

# Pier 1 imports®

INC

## 2006 Annual Report



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### **Pier 1 Imports, Inc.**

Pier 1 is undergoing the most revolutionary style shift in its history. Based on consumer research and an in-depth analysis of market trends, Pier 1's Modern Craftsman merchandise represents an evolution to more streamlined, contemporary designs that are relevant for today's consumers.



## TO OUR SHAREHOLDERS:

Fiscal year 2006 was a difficult year — but a formative one for Pier 1 Imports. We took steps to reposition the Company for a return to profitability in our core business. Historically, Pier 1's success has been founded on providing customers unique, ever-changing and proprietary merchandise with an exceptional in-store shopping environment. Additionally, Pier 1 stores are nationally recognized for being a fun place to shop with friendly and helpful sales associates. During fiscal 2006, we gathered significant customer feedback and research to support changes and initiatives for the development of our turnaround strategy. We know that we must work hard to regain the mind share of consumers through improvements in Pier 1's marketing and merchandising programs, while enhancing their shopping experience in our stores.

Pier 1 Imports reported net sales from continuing operations for fiscal year 2006 of \$1.78 billion, a decrease of 2.7% from last year's sales from continuing operations of \$1.83 billion, and comparable store sales declined 7.1%. The Company's net loss from continuing operations for fiscal 2006 was \$27.5 million or \$0.32 per share. Continuing operations exclude results for The Pier stores that were sold on March 20, 2006 and have been classified as discontinued operations for all periods presented.

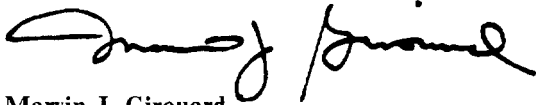
During fiscal 2006, the Company opened 65 and closed 32 North American Pier 1 stores bringing the store count to 1,183 at year end. The Company also opened one Pier 1 store and one store-within-a-store in Mexico and opened four and closed six Pier 1 Kids stores. The Company's store count for continuing operations totaled 1,259 at the end of fiscal 2006, which represents an increase of 3.2% in total retail square footage versus the year-ago period.

During fiscal 2006, we made several difficult decisions and a number of critical changes that are intended to help the Company achieve improvements in sales and profitability in fiscal year 2007.

- We launched the Company's new merchandising plans this spring supported by the introduction of new product offerings labeled Pier 1's Modern Craftsman. We believe that these new designs and fashion-forward color palettes are more relevant to today's consumers. The new merchandise reflects unique, contemporary styles, with beautiful detailing and global influences, and promises to continue to evolve as home furnishings' preferences shift.
- We revamped our national marketing campaign and launched new television commercials that are more product-focused. Additionally, we began distributing new nationwide catalogs that replaced promotional newspaper inserts. During fiscal 2006, we made operational changes and technology upgrades that made it possible for Pier 1 to begin a new direct-to-consumer channel through catalog distributions across the country. Initially, we believe this represents an effective advertising vehicle and longer term, this direct channel could create a much larger market potential for Pier 1 and Pier 1 Kids. We also will begin new magazine advertising with select, top-rated magazines.
- We restructured and realigned store operations, buying and administrative functions to cut costs and improve efficiencies throughout the organization.
- We issued convertible debt in fiscal 2006 to provide additional flexibility and financial wherewithal to implement new initiatives. We continue to have a strong balance sheet and ended fiscal 2006 with cash and cash equivalents of \$246 million.
- We carefully reevaluated the real estate portfolio for Pier 1 and Pier 1 Kids and decided to accelerate store closings on underperforming locations during fiscal years 2006 and 2007.
- In the fourth quarter of fiscal 2006, we made the decision to sell the U.K. subsidiary, The Pier stores, in order to focus on core business strategies in North America.
- We recently opened a new distribution center in the state of Washington to strategically improve the flow of goods to stores located in the Pacific Northwest and western Canada, which is a critical step as we implement a nationwide rapid replenishment program to all stores.
- We are currently reorganizing Pier 1 Kids to benefit from synergies with Pier 1 by consolidating the administrative offices and the distribution center with the Company's core operations.

Regarding the Company's charitable causes, we are proud of the participation of Pier 1 and Pier 1 Kids associates that donate time and money to support important philanthropic activities at the local, national and international levels. In our local community, we support the United Way of Metropolitan Tarrant County in Fort Worth, Texas. Associate donations are matched 100% by Company contributions. For 15 years we have supported the Susan G. Komen Breast Cancer Foundation on a national basis. Each year we sponsor associates, their friends and families who want to participate in Race for the Cure® events in cities across the U.S. Additionally, we sell our exclusive Komen Candle, with 25% of the proceeds from the sale of the candles donated to the Foundation for research to eradicate this life-threatening disease. Internationally, I have been involved for over 21 years with UNICEF, an organization supporting women and children throughout the world. Pier 1 Imports continues to be the largest retailer of UNICEF greeting cards with 100% of the proceeds from the card sales every holiday season donated to UNICEF to provide children with food, medicine and basic hygiene supplies — mostly in third-world countries. The Company's contributions to UNICEF have totaled over \$24 million during our 21-year partnership. We always give back to communities locally, nationally and internationally to support families, and especially women and children in need. Pier 1 Imports was recently honored with the 2006 Outstanding Corporation award by the Association of Fundraising Professionals, the largest association of charitable fundraisers in the world. The award recognizes Pier 1 and its associates for exceptional commitment to philanthropy and community involvement. I am very proud of this recognition.

We introduced Pier 1's new style of merchandise and improved marketing campaign in the spring of 2006 and although it is too early to call, we are hopeful that the changes will be enough to reinvigorate the brand and regain critical market share. We continue to work on the core business, and I believe we are making both informed and good decisions as we stay focused on our customers' shifting demands and shopping patterns. Again this year, I want to thank our loyal customers, suppliers, employees, Directors, and shareholders for their support in another year of transition. We look forward to reporting on the progress of our initiatives in the months ahead.

A handwritten signature in black ink, appearing to read 'Marvin J. Girouard', with a stylized flourish at the end.

**Marvin J. Girouard**  
Chairman and Chief Executive Officer



# **Form 10-K**

**Pier 1 imports®**

**2006 Annual Report**

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-K

- ☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended February 25, 2006

OR

- ☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File No. 1-7832

**PIER 1 IMPORTS, INC.**

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of  
incorporation or organization)

75-1729843

(I.R.S. Employer  
Identification No.)

100 Pier 1 Place  
Fort Worth, Texas

(Address of principal executive offices)

76102

(Zip Code)

Company's telephone number, including area code:

(817) 252-8000

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock, \$1.00 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

As of August 27, 2005, the approximate aggregate market value of voting stock held by non-affiliates of the registrant was \$938,000,000 using the closing sales price on that day of \$12.90. It is assumed for purposes of this computation that only directors, executive officers and 10% or greater shareholders of the registrant are affiliates, but this should not be deemed to be a conclusion that any such person is an affiliate of the registrant.

As of April 24, 2006, 87,083,398 shares of the registrant's common stock, \$1.00 par value, were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the following documents have been incorporated herein by reference:

- 1) Registrant's Proxy Statement for the 2006 Annual Meeting in Part III hereof.

**PIER 1 IMPORTS, INC.**  
**FORM 10-K ANNUAL REPORT**  
**Fiscal Year Ended February 25, 2006**  
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## PART I

### **Item 1. Business.**

#### **(a) General Development of Business.**

Throughout this report, references to the “Company” include Pier 1 Imports, Inc. and its consolidated subsidiaries. References to “Pier 1” relate to the Company’s retail locations operating under the name Pier 1 Imports®. References to “Pier 1 Kids” relate to the Company’s retail locations operating under the name Pier 1 Kids® and formerly named Cargokids®.

On March 20, 2006, the Company announced the sale of its subsidiary based in the United Kingdom, The Pier Retail Group Limited (“The Pier”). At fiscal 2006 year end, The Pier was classified as held for sale and included in discontinued operations for all years presented in the Company’s financial statements; therefore, all discussions in this report relate to continuing operations, unless stated otherwise.

In fiscal 2006, the Company expanded its specialty retail operations by opening 65 new Pier 1 stores, four new Pier 1 Kids stores and two new international stores. The Company closed 32 Pier 1 stores and six Pier 1 Kids stores. Subject to changes in the retail environment, availability of suitable store sites, lease renewal negotiations and availability of adequate financing, the Company plans to open approximately 40 new Pier 1 stores and close approximately 30 Pier 1 and five Pier 1 Kids stores during fiscal 2007. Plans for fiscal 2007 also include opening approximately seven new international stores in Mexico and Puerto Rico, primarily in a “store within a store” format.

Set forth below is a list by city of Pier 1 stores opened in North America in fiscal 2006:

Alabaster, AL	Garland, TX	Phoenix, AZ
Allen Park, MI	Georgetown, TX	Pitt Meadows, BC
Arden, NC	Gilbert, AZ	Pompano Beach, FL
Atlanta, GA	Glenwood Springs, CO	Raleigh, NC
Aurora, CO	Houston, TX (2 locations)	Rockaway, NJ
Bee Cave, TX	Jacksonville, FL	South Lake Tahoe, CA
Bellevue, WA	Kalamazoo, MI	Scarborough, ON
Bloomfield Hills, MI	Kingsport, TN	Seattle, WA
Bluffton, SC	Kissimmee, FL	Shreveport, LA
Bohemia, NY	Lady Lake, FL	Southhaven, MS
Calgary, AB	Lethbridge, AB	St. Joseph, MO
Castle Rock, CO	Machesney Park, IL	St. Louis Park, MN
Centerville, UT	Mesa, AZ	Stafford, VA
Cheshire, CT	Monroe, NC	Streamwood, IL
Chula Vista, CA	Morristown, TN	Studio City, CA
Colonial Heights, VA	Mundelein, IL	Tamarac, FL
Corona, CA	Newport News, VA	Thornton, CO
Cypress, TX	Newtown, PA	Union Gap, WA
Danville, VA	North Andover, MA	Westminster, CO
Durango, CO	Ocean, NJ	Williamsburg, VA
Feasterville, PA	Owasso, OK	
Fontana, CA	Petaluma, CA	

Presently, Pier 1 maintains regional distribution center facilities in or near Baltimore, Maryland; Chicago, Illinois; Columbus, Ohio; Fort Worth, Texas; Ontario, California; Savannah, Georgia; and Tacoma, Washington.

Pier 1 Kids stores offer children’s furniture and decorative accessories. The Company started operating Pier 1 Kids stores in March 2001. Pier 1 Kids utilizes an e-commerce site which can be accessed at [www.pier1kids.com](http://www.pier1kids.com) to attract customers and provide information regarding placing orders, sale items and store locations.

Set forth below is a list by city of Pier 1 Kids stores opened in North America in fiscal 2006:

Fort Worth, TX  
Houston, TX

Jacksonville, FL  
Rockaway, NJ

Pier 1 Kids maintains a distribution center facility in Fort Worth, Texas, which presently serves all its retail locations. The Company plans to complete the relocation of its Pier 1 Kids distribution center facility from its current location in Fort Worth, Texas to Pier 1's Savannah, Georgia distribution center facility by September 2006. In connection with this scheduled relocation, the Company will close Pier 1 Kids' Fort Worth, Texas distribution center facility at the end of its lease term.

The Company has an arrangement to supply Sears Roebuck de Mexico, S.A. de C.V. ("Sears Mexico") with Pier 1 merchandise to be sold primarily in a "store within a store" format in certain Sears Mexico stores. The agreement with Sears Mexico expires December 31, 2006, but is expected to be renewed under similar terms. This agreement is structured in a manner which substantially insulates the Company from currency fluctuations in the value of the Mexican peso. In fiscal 2006, Sears Mexico opened two new stores offering Pier 1 merchandise. As of February 25, 2006, Pier 1 merchandise was offered in 26 Sears Mexico stores. Expansion plans for fiscal 2007 include opening five new stores in Mexico.

The Company has a product distribution agreement with Sears Roebuck de Puerto Rico, Inc. ("Sears Puerto Rico"), which allows Sears Puerto Rico to market and sell Pier 1 merchandise in a "store within a store" format in certain Sears Puerto Rico stores. Sears Puerto Rico operates a total of ten stores, and as of February 25, 2006, seven of these stores offered Pier 1 merchandise. The Company is planning to open two new stores in Puerto Rico in fiscal 2007.

The Company owns a credit card bank in Omaha, Nebraska, operating under the name Pier 1 National Bank, N.A. (the "Bank"). The Bank holds the credit card accounts for both Pier 1 and Pier 1 Kids proprietary credit cards. As of February 25, 2006, the Company, through the Bank, had approximately 5,864,000 proprietary cardholders with approximately 1,033,000 active accounts (accounts with a purchase within the previous 12 months). Proprietary cardholders are among the Company's most loyal customers. Marketing and promotions targeted to cardholders take place throughout the year and may include deferred payment or no-interest options on larger purchases from time to time. The proprietary card offers a convenient method for observing the buying behavior of the Company's most active customers.

Since June 2000, Pier 1 has operated an e-commerce web site which received an average of 4.3 million visits per month in fiscal 2006, and can be accessed at [www.pier1.com](http://www.pier1.com). This site is a significant marketing vehicle for the Company while providing customers with access to Pier 1 products and services at their convenience as well as access to investor relations information. Customers can shop substantially all of Pier 1's merchandise assortment, as well as purchase gift cards, create and manage bridal and gift registries, view interactive catalogs, watch the most recent TV commercials and sign up for marketing email and direct mail. As part of Pier 1's continuing strategy of cross-channel integration, a new feature was implemented in March 2006 that allows web shoppers to check the availability of any item in their local stores. This feature sets Pier 1 apart from its competitors in the decorative home furnishings industry and leverages the Company's significant store base.

During the fall of 2005, the Company distributed its first two nation-wide catalogs, fall and holiday editions, of approximately two million copies each. In March 2006, ten million copies of a spring catalog were distributed to customers, followed by a five million copy distribution in late spring. The Company has plans for approximately nine direct mail catalogs in fiscal 2007. Full integration between the Company's e-commerce web site and direct mail catalogs was achieved during fiscal 2006.

The Pier, which was classified as held for sale at fiscal 2006 year end and included in discontinued operations for all periods presented, was a subsidiary of the Company as of February 25, 2006, with locations in the United Kingdom and Ireland. The Pier operates 45 retail stores offering decorative home furnishings and related items in a setting similar to Pier 1 stores. The Pier operates a distribution facility

near London, England. Additionally, The Pier has an online store, which can be accessed at [www.pier.co.uk](http://www.pier.co.uk). During fiscal 2006, The Pier opened 15 new stores, most of which operated in a "store within a store" format located in existing Debenhams stores in England, and closed two stores. The Pier's retail operations consist of 38 stores in England, four stores in Scotland, two stores in Ireland and one store in Wales. The Pier leases approximately 11,000 square feet of office space in the United Kingdom for its corporate office. The Pier also leases approximately 147,000 square feet of warehouse space in the United Kingdom for its operations. Approximately 900 associates were employed in the United Kingdom and Ireland, of which approximately 300 were full-time employees and approximately 600 were part-time employees. The sale of The Pier was completed on March 20, 2006. *(See Note 15 of the Notes to Consolidated Financial Statements set forth in Item 8 herein for additional information regarding subsequent events.)*

**(b) Financial Information about Industry Segments.**

In fiscal 2006, the Company conducted business as one operating segment consisting of the retail sale of imported decorative home furnishings, gifts and related items.

Financial information with respect to the Company's business is found in the Company's Consolidated Financial Statements, which are set forth in Item 8 herein.

**(c) Narrative Description of Business.**

The specialty retail operations of the Company consist of retail stores operating under the names "Pier 1 Imports" and "Pier 1 Kids", selling a wide variety of furniture, decorative home furnishings, dining and kitchen goods, bath and bedding accessories and other specialty items for the home.

On February 25, 2006, the Company operated 1,100 Pier 1 stores in the United States, 83 Pier 1 stores in Canada, and supported five franchised stores in the United States. All five franchise agreements expire in fiscal 2008. Additionally, the Company operated 43 Pier 1 Kids stores located in the United States. The Company expects to expand Pier 1 Kids nationally, offering value-oriented home furnishings for children and families. Growth plans include a catalog and direct-to-consumer business as well as expanding the concept to approximately 250 stores over the next decade. The Company supplies merchandise and licenses the Pier 1 Imports name to Sears Mexico and Sears Puerto Rico, which sell Pier 1 merchandise primarily in a "store within a store" format in 26 Sears Mexico stores and in seven Sears Puerto Rico stores. Company-operated Pier 1 stores in the United States and Canada average approximately 9,800 gross square feet, which includes an average of approximately 7,800 square feet of retail selling space. The stores consist of freestanding units located near shopping centers or malls and in-line positions in major shopping centers. Pier 1 operates in all major United States metropolitan areas and many of the primary smaller markets. Pier 1 stores generally have their highest sales volumes during November and December as a result of the holiday selling season. In fiscal 2006, net sales of the Company totaled \$1,776.7 million.

Pier 1 offers a diverse selection of products consisting of approximately 3,000 items imported from over 40 countries around the world. While the broad categories of Pier 1's merchandise remain constant, individual items within these product groupings change frequently in order to meet the demands of customers. The principal categories of merchandise include the following:

**FURNITURE** — This product group consists of furniture, furniture pads and pillows to be used on patios and in living, dining, kitchen and bedroom areas, and in sun rooms. This product group constituted approximately 40% of Pier 1's total North American retail sales in fiscal year 2006 and 39% in fiscal years 2005 and 2004. These goods are imported from a variety of countries such as Italy, Malaysia, Brazil, Mexico, China, the Philippines and Indonesia, and are also obtained from domestic sources. The furniture is made of metal or handcrafted natural materials, including rattan, pine, beech, rubberwood and selected hardwoods with either natural, stained or painted finishes. Pier 1 also sells upholstered furniture.

**DECORATIVE ACCESSORIES** — This product group constitutes the broadest category of merchandise in Pier 1's sales mix and contributed approximately 26% to Pier 1's total North American retail sales in fiscal year 2006, 25% in fiscal year 2005 and 24% in fiscal year 2004. These items are imported from approximately 35 countries and include brass, marble and wood items, as well as lamps, vases, dried and silk flowers, baskets, wall decorations and numerous other decorative items. A majority of these products are handcrafted from natural materials.

**HOUSEWARES** — This product group is imported mainly from the Far East and Europe and includes ceramics, dinnerware and other functional and decorative items. These goods accounted for approximately 13% of Pier 1's total North American retail sales in fiscal years 2006, 2005 and 2004.

**BED & BATH** — This product group is imported mainly from India, Germany, Thailand and China, and is also obtained from domestic sources. This group includes bath and fragrance products, candles and bedding. These goods accounted for approximately 15% of Pier 1's total North American retail sales in fiscal year 2006, 16% in fiscal year 2005 and 18% in fiscal year 2004.

**SEASONAL** — This product group consists of merchandise for celebrating holidays and spring/summer entertaining, imported mainly from Europe, Indonesia, China, the Philippines and India, and also obtained from domestic sources. These items accounted for approximately 6% of Pier 1's total North American retail sales in fiscal year 2006, 7% in fiscal year 2005 and 6% in fiscal year 2004.

Pier 1 merchandise largely consists of items that require a significant degree of handcraftsmanship and are mostly imported directly from foreign suppliers. For the most part, the imported merchandise is handcrafted in cottage industries and small factories. Pier 1 is not dependent on any particular supplier and has enjoyed long-standing relationships with many vendors and agents. The Company believes alternative sources of products could be procured over a relatively short period of time, if necessary. In selecting the source of a product, Pier 1 considers quality, dependability of delivery and cost. During fiscal 2006, Pier 1 sold merchandise imported from over 40 different countries with 35% of its sales derived from merchandise produced in China, 14% derived from merchandise produced in India, 13% derived from merchandise produced in the United States and 33% derived from merchandise produced in Indonesia, Brazil, Italy, Thailand, the Philippines, Vietnam and Mexico. The remaining 5% of sales was from merchandise produced in various Asian, European, Central American, South American and African countries.

Imported merchandise and a portion of domestic purchases are delivered to the Pier 1 distribution centers, unpacked and made available for shipment to the various stores in each distribution center's region. Due to the time delays involved in procuring merchandise from foreign suppliers, Pier 1 maintains a substantial inventory to assure a sufficient supply of products to its stores.

The Company, through certain of its wholly owned subsidiaries, owns a number of federally registered service marks under which Pier 1 Imports and Pier 1 Kids stores do business. Additionally, certain subsidiaries of the Company have registered and have applications pending for the registration of certain other Pier 1 and Pier 1 Kids trademarks and service marks in the United States and in numerous foreign countries. The Company believes that its marks have significant value and are important in its marketing efforts. The Company maintains a policy of pursuing registration of its marks and opposing any infringement of its marks.

The Company is in the highly competitive specialty retail business and competes primarily with specialty sections of large department stores, furniture and decorative home furnishings retailers, small specialty stores, discount stores, and catalog and Internet retailers. Management believes that the Company competes on the basis of price, value, rapidly changing merchandise assortments, visual presentations of its merchandise, customer service, and fashion sense. The Company also believes it remains competitive with other retailers because of its name recognition and established vendor relationships. The Company believes that its Pier 1 Kids business offers an opportunity to take advantage of the growing demand for children's furniture and accessories.

The Company allows customers to return merchandise within a reasonable time after the date of purchase without limitation as to reason. Most returns occur within 30 days of the date of purchase. The

Company monitors the level of and stated reasons for returns and maintains a reserve for future returns based on historical experience and other known factors.

On February 25, 2006, the Company employed approximately 18,200 associates in North America, of which approximately 8,500 were full-time employees and 9,700 were part-time employees.

**(d) Financial Information about Geographic Areas.**

Information required by this Item is found in “Note 1 — Summary of Significant Accounting Policies” of the section entitled “Notes to the Consolidated Financial Statements” set forth in Item 8 herein.

**(e) Available Information.**

The Company makes available free of charge through its Internet web site address ([www.pier1.com](http://www.pier1.com)) its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed with the Securities and Exchange Commission pursuant to Section 13(a) of the Securities Exchange Act of 1934 as soon as reasonably practicable after it electronically files such material with, or furnishes such material to, the Securities and Exchange Commission.

Certain statements contained in Item 1, Item 7 and elsewhere in this report may constitute “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934. The Company may also make forward-looking statements in other reports filed with the Securities and Exchange Commission and in material delivered to the Company’s shareholders. Forward-looking statements provide current expectations of future events based on certain assumptions. These statements encompass information that does not directly relate to any historical or current fact and often may be identified with words such as “anticipates,” “believes,” “expects,” “estimates,” “intends,” “plans,” “projects” and other similar expressions. Management’s expectations and assumptions regarding planned store openings, financing of Company obligations from operations, results from its new marketing, merchandising and store operations strategies, and other future results are subject to risks, uncertainties and other factors that could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements. Risks and uncertainties that may affect Company operations and performance include, among others, the effects of terrorist attacks or other acts of war, conflicts or war involving the United States or its allies or trading partners, labor strikes, weather conditions or natural disasters, volatility of fuel and utility costs, the general strength of the economy and levels of consumer spending, consumer confidence, the availability of new sites for expansion along with sufficient labor to facilitate growth, the availability and proper functioning of technology and communications systems supporting the Company’s key business processes, the ability of the Company to import merchandise from foreign countries without significantly restrictive tariffs, duties or quotas and the ability of the Company to source, ship and deliver items from foreign countries to its United States distribution centers at reasonable prices and rates and in a timely fashion. The foregoing risks and uncertainties are in addition to others discussed elsewhere in this report. The Company assumes no obligation to update or otherwise revise its forward-looking statements even if experience or future changes make it clear that any projected results expressed or implied will not be realized.

**Item 1A. Risk Factors.**

The following information describes certain significant risks and uncertainties inherent in the Company’s business that should be carefully considered, along with other information contained elsewhere in this report and in other filings, when making an investment decision with respect to the Company. If one or more of these risks actually occurs, the impact on the Company’s operations, financial position, or liquidity could be material and the business could be harmed substantially.



## **Strategic Risks and Strategy Execution Risks**

***The Company must be able to anticipate, identify and respond to changing trends and customer preferences for home furnishings.***

The success of the Company's specialty retail business depends upon its ability to predict trends in home furnishings consistently and to provide merchandise that satisfies consumer demand in a timely manner. Consumer preferences often change and may not be reasonably predicted. A majority of the Company's merchandise is manufactured, purchased and imported from countries around the world and is typically ordered well in advance of the applicable selling season. Extended lead times of four to twelve months may make it difficult to respond rapidly to changes in consumer demand and as a result the Company may be unable to react quickly and source needed merchandise. Also, the Company's vendors may not have the ability to handle its increased demand for product. The seasonal nature of the specialty home furnishing business leads the Company to purchase and requires it to carry a significant amount of inventory prior to its peak selling season. As a result, the Company may be vulnerable to changes in evolving home furnishing trends, customer preferences, pricing shifts, and may misjudge the timing and selection of merchandise purchases. The Company's failure to anticipate, predict and respond in a timely manner to changing home furnishing trends could lead to lower sales and additional promotional discounts and clearance markdowns in an effort to clear merchandise, which could have a negative impact on merchandise margins and in turn the results of operations.

***Failure to control merchandise returns could negatively impact the business.***

The Company has established a provision for estimated merchandise returns based upon historical experience and other known factors. If actual returns are greater than those projected by management, additional sales returns could be recorded in the future. Also, to the extent that returned merchandise is damaged, the Company may not receive full retail value from the resale of the returned merchandise. Introductions of new merchandise, changes in merchandise mix, merchandise quality issues, changes in consumer confidence, or other competitive and general economic conditions may cause actual returns to exceed the provision for estimated merchandise returns. An increase in merchandise returns that exceeds the Company's current provisions could negatively impact the business and operating results.

***The success of the business is dependent on factors affecting consumer spending that are not controllable by the Company.***

Consumer spending, including spending for the home and home-related furnishings, are dependent upon factors that include but are not limited to general economic conditions, levels of employment, disposable consumer income, prevailing interest rates, consumer debt, costs of fuel, recession and fears of recession, war and fears of war, inclement weather, tax rates and rate increases, consumer confidence in future economic conditions and political conditions, and consumer perceptions of personal well-being and security. Unfavorable changes in factors affecting discretionary spending could reduce demand for the Company's products and therefore lower sales and negatively impact the business and its operating results.

***The Company intends to expand its direct to consumer business in an effort to continue to grow and may face challenges that may cause these expansion plans to fail.***

The Company currently operates an e-commerce web site which serves as a marketing vehicle for the business and provides consumers access to its products and services at their convenience. The Company believes its introduction of the catalog business has allowed it to focus on cross-channel integration and to more effectively utilize its web site to reach new and existing customers. The Company plans to fully integrate its direct to consumer business by the end of fiscal 2007 with the introduction of delivery of products direct to the customer's home or to their local Pier 1 store, at their request. The newest channel of direct to consumer business is expected to play a more critical role to the growth of the business and will complement the Company's current retail locations, e-commerce web site and catalog business.

***Failure to successfully manage and execute our marketing initiatives could have a negative impact on the business.***

The continued success and growth of the Company has become dependent on improving customer traffic in order to gain sales momentum in its stores and on its e-commerce web site. Historically, the Company has utilized various media to reach the consumer and it has experienced varying levels of favorable response to its marketing efforts. Often media placement decisions are made months in advance and the Company's inability to accurately predict its consumers preferred method of communication may negatively impact the business and operating results.

### **Risks Related to Profitable Growth**

***The Company's success depends, in part, on its ability to find desirable new locations at reasonable rental rates and close underperforming stores at or before the conclusion of their lease terms.***

Historically, the continued growth of the business has been highly dependent on opening and operating new stores at a reasonable profit. While management is currently executing a very disciplined growth strategy, the Company will continue to pursue new store locations. The ability to continue to open additional stores successfully will depend upon a number of factors, many of which are beyond the Company's control, including identification and availability of suitable store locations; negotiation of favorable lease terms; securing required governmental permits and approvals; availability of construction materials and labor at reasonable prices; obtaining financing on acceptable terms; and general economic conditions.

For a majority of the Company's current store base, a large portion of a stores' operating expense is its costs associated with leasing the location. Management actively monitors individual store performance to ensure stores can remain profitable or have the ability to rebound to a profitable state. Current locations may not continue to be desirable as demographics may adversely change and we may choose to close an underperforming store before its lease expires. If management chooses to close an existing store before its lease expiration, the Company could suffer operating losses until the lease term expires or until the lease arrangement has been restructured or the lease obligation has been settled.

***Failure to attract and retain an effective management team or changes in the costs or availability of a suitable workforce to manage and support the Company's stores and distribution facilities could adversely affect the business.***

The Company's success is dependent, in a large part, on being able to successfully attract, motivate and retain a qualified management team and employees. Sourcing qualified candidates to fill important positions within the Company, especially management, in the highly competitive retail environment may prove to be a challenge. The inability to recruit and retain such individuals could result in turnover in our stores and distribution facilities, which could have an adverse effect on the business. Management will continue to assess the Company's compensation structure in an effort to attract future qualified candidates or retain current experienced management team members.

Occasionally the Company experiences union organizing activities in its non-unionized distribution facilities. These types of activities may result in work slowdowns or stoppages and higher labor costs. Any increase in costs associated with labor organization at our distribution facilities could result in higher costs to distribute inventory and could negatively impact merchandise margins.

***Factors affecting the general strength of the economy, should they decline, could result in reduced consumer demand for the Company's products.***

The Company's successful execution relies on customer demand for its merchandise, which is affected by factors that are impacted by prevailing economic conditions. A general slowdown in the United States economy and an uncertain economic outlook may adversely affect consumer spending which in turn could

result in lower sales and unfavorable operating results. A prolonged economic downturn could have a material adverse effect on the business, and its financial condition and results of operations.

***The Company operates in a highly competitive retail environment with companies offering similar merchandise to ours, and if customers are lost to our competitors, sales could decline.***

The Company's retail locations, e-commerce web site and direct mail catalog business operate in the highly competitive specialty retail business competing with specialty sections of large department stores, home furnishing stores, small specialty stores, discount stores and catalog and Internet retailers. Management believes that in addition to competing for sales, it competes on the basis of pricing and quality of products, constantly changing merchandise assortment, visual presentation of its merchandise and customer service. The Company also believes its Pier 1 operations are competitive with other retailers due to brand awareness and name recognition, established vendor relationships and the extent and variety of the merchandise offered. The level of competition is not anticipated to decrease and if the Company is unable to maintain a competitive position, it could experience negative pressure on retail prices which in turn could result in reduced merchandise margins and operating results.

***Increases in certain operating costs that are not entirely controllable by the Company may have a significant impact on the Company's profitability.***

The Company needs to manage its operating costs effectively and continue to look for opportunities to reduce these costs. Such costs include; rent, fuel and utility costs, delivery expenses, postage, advertising media and production costs (including the cost of paper and printing), and costs of obtaining commercial insurance.

***The Company's business is subject to seasonal variations, with a significant portion of its sales and earnings occurring during two months of the year.***

Approximately 25% of the Company's sales generally occur during the November-December holiday selling season. Failure to predict consumer demand correctly during these months could result in lost sales or gross margin erosion if merchandise must be marked down to clear inventory.

***The Company's business may be harmed by adverse weather conditions and natural disasters.***

Extreme or undesirable weather can affect customer traffic in retail stores as well as customer shopping behavior. Natural disasters such as earthquakes, weather phenomena, and events causing infrastructure failures could adversely affect any of the Company's retail locations, distribution centers, administrative facilities, ports, or locations of its suppliers domestically and in foreign countries.

#### **Risks Associated with Dependence on Technology**

***The Company is heavily dependent on various kinds of technology in the operation of its business.***

Failure of any critical software applications, technology infrastructure, telecommunications, data communications, or networks could have a material adverse effect on the Company's ability to manage the merchandise supply chain, sell products, accomplish payment functions or report financial data. Some business processes that are dependent on technology are outsourced to third parties. Such processes include gift card tracking and authorization, credit card authorization and processing, catalog and e-commerce fulfillment, insurance claims processing, processing and payment of payroll outside the United States, and record keeping for retirement plans. The Company makes a diligent effort to insure that all providers of outsourced services observe proper internal control practices, such as redundant processing facilities; however, there are no guarantees that failures will not occur. Failure of third parties to provide adequate services could have an adverse effect on the Company's results of operations, liquidity, or ability to accomplish its financial and management reporting.

## **Regulatory Risks**

*The Company is subject to laws and regulatory requirements in many jurisdictions. Changes in these laws and requirements may result in additional costs to the Company, including the costs of compliance as well as potential penalties for non-compliance.*

The Company operates in many local, state, and federal taxing jurisdictions, including foreign countries. In most of these jurisdictions the Company is required to collect state and local sales taxes at the point of sale and remit them to the appropriate taxing authority. The Company is also subject to income taxes, excise taxes, franchise taxes, and other special taxes. The Company is also required to maintain various kinds of business and commercial licenses to operate its stores and other facilities. Rates of taxation are beyond the Company's control, and increases in such rates or taxation methods and rules could have a material impact on the Company's profitability. Failure to comply with laws concerning the collection and remittance of taxes and with licensing requirements could also subject the Company to financial penalties or business interruptions.

Local, state, and federal legislation also has a potential material effect on the Company's profitability or ability to operate its business. Compliance with certain legislation carries with it significant costs. The Company is subject to oversight by many governmental agencies in the course of operating its business because of its numerous locations, large number of employees, contact with consumers, granting of credit, and importation and exportation of product. Insuring compliance with regulations may cause the Company to incur significant expenses, including the costs associated with periodic audits. Failure to comply may also cause additional costs in the form of penalties.

## **Risks Associated with International Trade**

*As a retailer of imported merchandise, the Company is subject to certain risks that typically do not affect retailers of domestically produced merchandise.*

The Company usually orders merchandise from four to twelve months in advance of delivery and generally pays for the merchandise at the time it is loaded for transport to designated United States destinations. Global political unrest, war, threats of war, terrorist acts or threats, especially threats to foreign and U.S. ports, could affect the Company's ability to import merchandise from certain countries. Fluctuations in foreign currency exchange rates, restrictions on the convertibility of the dollar and other currencies, duties, taxes and other charges on imports, dock strikes, import quota systems and other restrictions sometimes placed on foreign trade can affect the price, delivery and availability of imported merchandise as well as exports to the Company's stores in other countries. The inability to import products from certain countries, unavailability of adequate shipping capacity at reasonable rates, or the imposition of significant tariffs could have a material adverse effect on the results of operations of the Company. Freight costs contribute a substantial amount to the cost of imported merchandise. Monitoring of foreign vendors' compliance with United States laws and Company standards, including quality standards, is more difficult than monitoring of domestic vendors.

The United States government has the authority to enforce trade agreements, resolve trade disputes, and open foreign markets to United States goods and services. The United States government may also impose trade sanctions on foreign countries that are deemed to violate trade agreements or maintain laws or practices that are unjustifiable and restrict United States commerce. In these situations the United States government may increase duties on imports into the United States from one or more foreign countries. In this event, Pier 1 could be adversely affected by the imposition of trade sanctions.

In addition, the United States maintains in effect a variety of additional international trade laws under which the Company's ability to import may be affected from time to time, including, but not limited to, the antidumping law, the countervailing duty law, the safeguards law, and laws designed to protect intellectual property rights. Although the Company may not be directly involved in a particular trade

dispute under any of these laws, its ability to import, or the terms and conditions under which it can continue to import, may be affected by the outcome of that dispute.

In particular, because the Company imports merchandise from countries around the world, the Company may be affected from time to time by antidumping petitions filed with the United States Commerce Department and International Trade Commission by United States producers of competing products alleging that foreign manufacturers are selling their own products at prices in the United States that are less than the prices that they charge in their home country market or in third country markets or at less than their cost of production. Such petitions, if successful, could significantly increase the United States import duties on those products. In that event, the Company might possibly decide to pay the increased duties, thereby possibly increasing the Company's price to consumers. Alternatively, the Company might decide to source the product or a similar product from a different country not subject to increased duties or else discontinue the importation and sale of the product.

In recent years, dispute resolution processes have been utilized to resolve disputes regarding market access between the European Union, China, the United States and other countries. In some instances these trade disputes can lead to the threats by countries of sanctions against each other, which can include import prohibitions and increased duty rates on imported items. The Company considers any agreement that reduces tariff and non-tariff barriers in international trade beneficial to its business. Any type of sanction on imports is likely to increase the Company's import costs or limit the availability of products purchased from sanctioned countries. In that case, the Company may be required to seek similar products from other countries.

### **Risks Relating to Liquidity**

***Insufficient cash flows from operations could result in the substantial utilization of the Company's secured credit facility which may impose certain financial covenants.***

The Company maintains a secured credit facility to enable it to issue merchandise and special purpose standby letters of credit as well as occasionally to fund working capital requirements. Borrowings under the credit facility are subject to a borrowing base calculation consisting of a percentage of eligible inventory and third party credit card receivables. Substantial utilization of the availability under the borrowing base will result in various restrictions on the Company including: restricting the ability of the Company to repurchase its common stock or pay dividends, dominion over the Company's cash accounts, and requiring compliance with a minimum fixed charge coverage ratio. While the Company does not anticipate the use of the facility for working capital purposes in the next twelve months, significant decreases in cash flow from operations and investing could result in the Company's borrowing increased amounts under the credit facility to fund operational needs and potentially being subjected to these limitations.

***Changes in the Company's credit rating may result in a significant decrease in cash available for the Company's use.***

The Company's credit card securitization program, which is more fully described in the Notes to the Consolidated Financial Statements included in Item 8 of this report, requires that the Company maintain a minimum credit rating. Should the Company have its credit rating fall more than one notch, or have its rating withdrawn, the certificate holders (as described in the Notes to Consolidated Financial Statements set forth in Item 8 herein) would be entitled to retain funds collected on the outstanding credit card receivables until the certificate holders have been repaid amounts owed. To avoid such an event, the Company's non-consolidated subsidiary would endeavor to amend the securitization agreement to lower the minimum acceptable credit rating or eliminate the rating requirement. In the past, the Company's non-consolidated subsidiary has been able to amend its securitization agreement as needed; however, there are no assurances that future amendments will be obtainable. If such an event were not avoided, it could negatively impact the Company's liquidity position as it would reduce the non-consolidated subsidiary's funds available to purchase newly generated proprietary credit card receivables from the Company and

could further result in defaults under other agreements, including the Company's secured credit facility. A default under the secured credit facility that remains uncured or that was not waived by the lenders would cause severe limitations on the Company's ability to issue letters of credit or borrow funds to cover operational needs, which would negatively impact the business.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

In March 2002, the Company purchased land in Fort Worth, Texas for construction of its new headquarters and relocation of its corporate offices. The Company completed the construction and relocated to its new corporate headquarters building in August 2004. The facility contains approximately 460,000 square feet of office space, which is intended to accommodate the Company's future growth. Total cost of the new headquarters, including land, was approximately \$100 million, of which \$34 million was spent in fiscal 2005, \$53 million was spent in fiscal 2004, and \$13 million was spent in fiscal 2003. The Company leases approximately 21,000 square feet of office space for its Pier 1 Kids subsidiary, also located in Fort Worth, Texas. The Company plans to transition Pier 1 Kids' administrative offices to its corporate headquarters during fiscal 2007 upon or prior to expiration of that lease in September.

The Company leases the majority of its retail stores, its warehouses and other office space. At February 25, 2006, the present value of the Company's minimum future operating lease commitments discounted at 10% totaled approximately \$979 million. The Company currently owns and leases distribution space of approximately five million square feet. The Company also acquires temporary distribution space from time to time through short-term leases.

The following table sets forth the distribution of Pier 1's North American stores by state and province as of February 25, 2006:

**United States (company-operated)**

Alabama .....	18	Louisiana .....	16	Ohio .....	40
Alaska .....	1	Maine .....	1	Oklahoma .....	7
Arizona .....	24	Maryland .....	25	Oregon .....	13
Arkansas .....	8	Massachusetts .....	29	Pennsylvania .....	42
California .....	116	Michigan .....	41	Rhode Island .....	4
Colorado .....	29	Minnesota .....	20	South Carolina .....	19
Connecticut .....	21	Mississippi .....	8	South Dakota .....	2
Delaware .....	4	Missouri .....	23	Tennessee .....	23
Florida .....	77	Montana .....	6	Texas .....	86
Georgia .....	36	Nebraska .....	6	Utah .....	13
Hawaii .....	3	Nevada .....	9	Virginia .....	37
Idaho .....	6	New Hampshire .....	6	Washington .....	26
Illinois .....	48	New Jersey .....	34	West Virginia .....	5
Indiana .....	22	New Mexico .....	5	Wisconsin .....	21
Iowa .....	9	New York .....	47	Wyoming .....	1
Kansas .....	9	North Carolina .....	39		
Kentucky .....	11	North Dakota .....	4		

**United States (franchised)**

Arizona .....	1	Nevada .....	1	Texas .....	1
Kentucky .....	1	New Hampshire .....	1		

**Canada (company-operated)**

Alberta .....	11	New Brunswick .....	2	Ontario .....	36
British Columbia .....	13	Newfoundland .....	1	Quebec .....	15
Manitoba .....	2	Nova Scotia .....	1	Saskatchewan .....	2

At the end of fiscal 2006, Pier 1 Kids had fifteen stores in Florida, nine stores in North Carolina, eight stores in Texas, three stores in Georgia, three stores in Virginia, two stores in Maryland, one store in Alabama, one store in Delaware and one store in New Jersey.

As of February 25, 2006, the Company owned or leased the following warehouse properties in or near the following cities:

<u>Location</u>	<u>Approx. Sq. Ft.</u>	<u>Owned/Leased Facility</u>
<u>Pier 1</u>		
Baltimore, Maryland .....	981,000 sq. ft.	Leased
Chicago, Illinois .....	514,000 sq. ft.	Owned
Columbus, Ohio .....	527,000 sq. ft.	Leased
Fort Worth, Texas .....	460,000 sq. ft.	Owned
Fort Worth, Texas .....	315,000 sq. ft.	Leased
Ontario, California .....	747,000 sq. ft.	Leased
Savannah, Georgia .....	784,000 sq. ft.	Leased
<u>Pier 1 Kids</u>		
Fort Worth, Texas .....	373,000 sq. ft.	Leased

In support of its long-range growth plans, the Company began expanding its distribution facilities in fiscal 2006. A new distribution facility was constructed under a build-to-suit arrangement and the resulting lease qualified for operating lease treatment. This facility is located near Tacoma, Washington and began operations in March 2006. The Company is currently utilizing approximately 451,000 square feet in the facility which is expandable to 692,000 square feet. During fiscal 2007, the Company plans to transition Pier 1 Kids distribution facilities from Fort Worth to Savannah, closer to its store base, upon expiration of the lease on that facility.

**Item 3. Legal Proceedings.**

There are various claims, lawsuits, investigations and pending actions, against the Company and its subsidiaries incident to the operations of its business. The Company considers them to be ordinary and routine in nature. The Company maintains liability insurance against most of these claims. While certain of the lawsuits involve substantial amounts, it is the opinion of management, after consultation with counsel, that the ultimate resolution of such litigation will not have a material adverse effect on the Company's financial position, results of operations or liquidity. The Company intends to vigorously defend itself against the claims asserted in these lawsuits.

**Item 4. Submission of Matters to a Vote of Security Holders.**

There were no matters submitted to a vote of the Company's security holders during the fourth quarter of the Company's 2006 fiscal year.

## PART II

### **Item 5. Market for the Company's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

The Company's common stock is traded on the New York Stock Exchange (the "NYSE"). As of April 24, 2006, there were approximately 9,600 shareholders of record of the Company's common stock.

The following tables show the high and low closing sale prices on the NYSE, as reported in the consolidated transaction reporting system, and the dividends paid per share, for each quarter of fiscal 2006 and 2005.

<u>Fiscal 2006</u>	<u>Market Price</u>		<u>Cash Dividends per Share</u>
	<u>High</u>	<u>Low</u>	
First quarter .....	\$19.42	\$14.35	\$.10
Second quarter .....	16.79	12.90	.10
Third quarter .....	13.37	9.96	.10
Fourth quarter .....	13.36	8.56	.10
<u>Fiscal 2005</u>			
First quarter .....	\$25.00	\$18.30	\$.10
Second quarter .....	18.80	15.43	.10
Third quarter .....	19.74	17.10	.10
Fourth quarter .....	19.78	17.61	.10

Information required with respect to equity compensation plan information can be found in Item 11 of this report.

In June 2004, the Company's Board of Directors authorized up to \$150 million for purchases of common stock, replacing the previous authorization. During fiscal 2006, the Company repurchased 250,000 shares of its outstanding common stock. As of April 24, 2006, approximately \$107.4 million of the authorization remains available. Future repurchases of common stock may be made in open market or private transactions from time to time depending on prevailing market conditions, the Company's available cash and the Company's consideration of any loan agreement restrictions and its corporate credit ratings.

There were no purchases of common stock of the Company made during the three months ended February 25, 2006, by Pier 1 Imports, Inc. or any "affiliated purchaser" of Pier 1 Imports, Inc. as defined in Rule 10b-18(a)(3) under the Exchange Act of 1934.

The Company is not required to comply with financial covenants under its new secured credit facility unless the availability under such agreement is less than \$32.5 million. The Company had no cash borrowings outstanding under its credit facility, and the Company was in compliance with all material debt covenants at fiscal 2006 year-end. The Company was granted a waiver by the lenders subsequent to year-end in connection with the restatement of the Company's consolidated statements of cash flows for fiscal 2005 and 2004. During fiscal 2006, the Company paid cash dividends totaling approximately \$34.7 million, or \$0.40 per share. In March 2006, the Company declared a cash dividend of \$0.10 per share payable on May 17, 2006, to shareholders of record on May 3, 2006. The Company may continue to pay cash dividends and repurchase its common stock in fiscal 2007, but expects to retain most of its future earnings for support and expansion of the Company's business. The Company's dividend policy will depend upon the earnings, financial condition and capital needs of the Company and other factors deemed relevant by the Company's Board of Directors. Dividend payments are not restricted by the new secured credit facility unless the availability under the credit facility is less than 30% of the Company's borrowing base calculation. Such borrowing base calculation consists of a percentage of eligible inventory and third party credit card receivables and varies according to the levels of the underlying collateral.



Item 6. Selected Financial Data.

FINANCIAL SUMMARY

	Year Ended				
	2006	2005	2004	2003	2002
	(\$ in millions except per share amounts)				
SUMMARY OF OPERATIONS*:					
Net sales .....	\$1,776.7	1,825.3	1,806.1	1,703.4	1,505.1
Gross profit .....	\$ 601.7	703.6	760.9	736.4	636.9
Selling, general and administrative expenses .....	\$ 588.3	549.6	526.1	487.0	435.7
Depreciation and amortization .....	\$ 56.2	55.8	48.9	44.7	41.2
Operating income (loss) .....	\$ (42.8)	98.2	186.0	204.8	160.0
Nonoperating (income) and expenses, net .....	\$ (0.9)	(0.9)	(1.0)	(0.6)	(0.1)
Income (loss) from continuing operations before income taxes .....	\$ (41.9)	99.1	187.0	205.6	160.1
Income (loss) from continuing operations, net of tax ...	\$ (27.5)	62.8	117.7	129.6	101.3
Income (loss) from discontinued operations, net of tax .....	\$ (12.3)	(2.3)	0.3	(0.3)	(1.1)
Net income (loss) .....	\$ (39.8)	60.5	118.0	129.4	100.2
PER SHARE AMOUNTS:					
Basic earnings (loss) from continuing operations .....	\$ (.32)	.72	1.32	1.40	1.07
Diluted earnings (loss) from continuing operations ...	\$ (.32)	.71	1.29	1.36	1.05
Basic earnings (loss) from discontinued operations ...	\$ (.14)	(.03)	.00	(.00)	(.01)
Diluted earnings (loss) from discontinued operations ...	\$ (.14)	(.03)	.00	(.00)	(.01)
Basic earnings (loss) consolidated .....	\$ (.46)	.69	1.32	1.39	1.06
Diluted earnings (loss) consolidated .....	\$ (.46)	.68	1.29	1.36	1.04
Cash dividends declared .....	\$ .40	.40	.30	.21	.16
Shareholders' equity .....	\$ 6.81	7.63	7.66	6.93	6.20
OTHER FINANCIAL DATA:					
Working capital .....	\$ 486.1	387.4	433.0	432.3	408.6
Current ratio .....	2.7	2.3	2.5	2.8	3.0
Total assets .....	\$1,169.9	1,075.7	1,052.2	972.7	867.3
Long-term debt .....	\$ 184.0	19.0	19.0	25.0	25.4
Shareholders' equity .....	\$ 590.0	664.4	683.6	643.9	585.7
Weighted average diluted shares outstanding (millions) .....	86.6	88.8	91.6	95.3	96.2
Effective tax rate .....	34.5%	36.7	37.1	37.0	36.7
Return on average shareholders' equity .....	(4.4%)	9.3	17.7	21.1	18.1
Return on average total assets .....	(2.4%)	5.9	11.6	14.1	12.6
Pre-tax return on sales .....	(2.4%)	5.4	10.4	12.1	10.6

\* Amounts are from continuing operations unless otherwise specified.

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

**MANAGEMENT OVERVIEW**

**Introduction**

Pier 1 Imports, Inc. (together with its consolidated subsidiaries, the "Company") is one of North America's largest specialty retailers of unique decorative home furnishings, gifts and related items. The Company imports merchandise directly from over 40 countries, and sells a wide variety of furniture collections, decorative accessories, bed and bath products, housewares and other seasonal assortments in its stores. During fiscal year 2006, the Company opened 86 new stores and closed 40 stores, increasing retail square footage 3.6% over the prior year. The Company operates stores in the United States and Canada under the names "Pier 1 Imports" ("Pier 1"), and "Pier 1 Kids." Pier 1 Kids stores sell children's home furnishings and decorative accessories. In the United Kingdom and Ireland, retail locations have operated under the name "The Pier." As of February 25, 2006, the Company operated 1,304 stores in the United States, Canada, Puerto Rico, the United Kingdom, Ireland and Mexico.

During the fourth quarter of fiscal 2006, the Company's Board of Directors authorized management to sell its operations of The Pier stores and concessions located in the United Kingdom and Ireland. The Company met the criteria of Statement of Financial Accounting Standards, No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" that allowed it to classify The Pier as held for sale and present its results of operations as discontinued at year-end, with prior periods reclassified accordingly. On March 20, 2006, the Company sold The Pier to Palli Limited for approximately \$15.0 million. Palli Limited is a wholly owned subsidiary of Lagerinn ehf, an Iceland corporation owned by Jakup a Dul Jacobsen. According to Mr. Jacobsen's Schedule 13D filing, collectively Lagerinn and Mr. Jacobsen beneficially owned approximately 9.9% of the Company's common stock on March 20, 2006.

The following discussion and analysis of financial condition, results of operations, liquidity and capital resources relates to continuing operations, unless otherwise stated, and should be read in conjunction with the accompanying audited Consolidated Financial Statements and notes thereto which can be found in Item 8 of this report.

**Overview of Business**

Net sales from continuing operations decreased 2.7% to \$1,776.7 million in fiscal 2006 compared to \$1,825.3 million in fiscal 2005, and comparable store sales declined 7.1%. The Company's net loss from continuing operations was \$27.5 million during fiscal 2006, or \$0.32 per share compared with diluted earnings per share of \$0.71 for the prior fiscal year. The Company ended the year with \$246.1 million in cash and cash equivalents. Throughout the year, the Company continued to pay cash dividends to shareholders.

The Company's key financial and operational metrics used by management to evaluate the performance of the business include the following (trends for these metrics are explained in the comparative sections of this section):

<u>Key Performance Metrics</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
<b>Continuing operations:</b>			
Total sales growth .....	(2.7)%	1.1%	6.0%
Comparable stores sales growth .....	(7.1)%	(6.1)%	(2.6)%
Sales per average retail square foot .....	\$ 189	\$ 205	\$ 222
Merchandise margins as a % of sales .....	50.2%	53.1%	55.3%
Gross profit as a % of sales .....	33.9%	38.5%	42.1%
Selling, general and administrative expenses as a % of sales	33.1%	30.1%	29.1%
Operating income (loss) from continuing operations as a % of sales .....	(2.4)%	5.4%	10.3%
Income (loss) from continuing operations as a % of sales ...	(1.5)%	3.4%	6.5%
Diluted earnings (loss) per share from continuing operations	\$ (0.32)	\$ 0.71	\$ 1.29
Inventory per retail square foot .....	\$ 38.88	\$ 39.78	\$ 42.17
Total retail square footage (in thousands) .....	9,491	9,194	8,548
Total retail square footage growth .....	3.2%	7.5%	10.3%

Stores included in the comparable store sales calculation are those stores that were opened prior to the beginning of the preceding fiscal year and are still open. Also included are stores that were relocated during the year within a specified distance serving the same market, where there is not a significant change in store size and where there is not a significant overlap or gap in timing between the opening of the new store and the closing of the existing store. Stores that are expanded or renovated are excluded from the comparable store sales calculation during the period they are closed for such remodeling. When these stores re-open for business, they are included in the comparable store sales calculation in the first full month after the re-opening if there is no significant change in store size. If there is a significant change in store size, the store continues to be excluded from the calculation until it meets the Company's established definition of a comparable store. Sales over the Internet (which includes direct sales from catalog) are also included.

Throughout fiscal 2006, the Company continued to struggle with declining sales performance. Challenged with how to increase customer traffic and differentiate itself from the growing competition, the Company implemented several key initiatives. To regain its position as a unique specialty retailer, the Company is focusing on merchandising and marketing strategies as well as prudent management of the business through cost reductions and other restructuring plans throughout the organization.

Through market research and customer feedback, the Company determined that the stores needed an updated look; complete with new merchandise lines and a redesigned store format. Market research showed that customers are looking for a "less is more" style of home furnishings, with more efficient and convenient shopping options. As a result, the Company has introduced a new line of merchandise with more contemporary designs, updated color palettes and a modern look. In addition to shelf displays, customers entering Pier 1 stores will now find merchandise arrangements designed to fit into particular areas of the home such as the living room, dining room, bedroom or patio. The new merchandise is displayed in a manner that allows the customers to imagine what it would look like in their own homes, as well as showing them how to incorporate different accessories into their living areas. This simplified, less cluttered visual presentation was partially achieved by reducing the total number of SKUs at the stores. In addition, the Company recently implemented a new rapid replenishment process in its stores where more merchandise is now held at the distribution centers rather than in stores and is restocked as merchandise sells. This new process has removed at least a week from the restocking time in stores and helped to maintain the clean, contemporary look of the stores. Also, during the fourth quarter the Company doubled

its number of outlet stores to help with the flow of merchandise and to keep the stores from appearing cluttered as the Company transitions merchandise throughout the year.

In addition to the new merchandise initiatives, the Company has implemented new marketing strategies including new television advertisements, catalog mailings, magazine advertisements, and direct mail and Internet marketing. The Company has returned to television advertising after discontinuing this form of advertising in the latter half of fiscal 2005 and has discontinued the use of newspaper inserts for now.

The Company began test marketing its catalog through limited mailings late in fiscal 2005 and again in early fiscal 2006 and decided to expand the mailings of catalogs with two nation-wide distributions during the fall and holiday season of fiscal 2006. Customer response was positive and the Company has decided to continue to expand this form of marketing and discontinue the use of newspaper inserts. The catalog offers an opportunity to show product to its best advantage, to suggest its use in home settings and to demonstrate the value proposition. In March 2006, the Company circulated ten million copies of the spring catalog. In April, the Company circulated a late spring edition of the catalog and will follow it with a summer catalog in May. In all, the Company plans to distribute nine direct mail catalogs throughout fiscal 2007. The Company's management feels that the catalogs will play an increasingly important role in the overall marketing plan as well as provide the Company with future business opportunities. Almost all items available through catalogs and Internet shopping are also available in stores.

In an effort to reduce costs and focus on the core business, the Company has made several key changes throughout the year, as follows:

The Company's management reviewed and identified key areas of the Company where cost reduction and cost restructuring would be beneficial. As a result, the Company made the decision to integrate Pier 1 Kids operations within Pier 1 more fully by moving its administrative functions to Pier 1's corporate headquarters and utilizing the Savannah distribution center for distribution to Pier 1 Kids stores. In addition, the Company centralized the field administration function, reduced the number of regions and districts and eliminated associated support functions, and reduced the staffing of the real estate function. Also, overall information technology spending was reduced where practical and a number of corporate administrative positions were eliminated.

During the fourth quarter of fiscal 2006, the Company's management began a comprehensive evaluation of its real estate portfolio of Pier 1 and Pier 1 Kids stores. As a result of this evaluation, the Company's management decided to close 38 stores in fiscal 2006, compared to the original plan to close 27, and expects to close 35 in fiscal 2007. The increase in closures is an effort to focus on the stores in the higher performing markets and not continue to invest resources in marginal or underperforming stores.

Lastly, management decided to sell The Pier stores located in the United Kingdom and Ireland. Managing operations in distant locations was a management distraction, and the Company has chosen to focus on operations in North America. Additionally, the stores opened in North America have historically provided a higher return on investment than those opened in the United Kingdom, and the Company determined that it would be a better use of its capital to focus its expansion efforts in North America.

Despite a difficult year, the Company's management continues to focus on managing inventory levels and controlling operating expenses prudently. The Company plans to continue to monitor customer preferences as they shift each season, and to adjust the Company's marketing and merchandising strategies to meet the needs of its customers. Customers have responded favorably to the new merchandising and marketing strategies and management believes that the steps it is taking will help to increase customer traffic and sales.

# **FISCAL YEARS ENDED FEBRUARY 25, 2006 AND FEBRUARY 26, 2005**

## **Net Sales**

Net sales consisted almost entirely of sales to retail customers, net of discounts and returns, but also included delivery service revenues and wholesale sales and royalties received from franchise stores and Sears Roebuck de Mexico, S.A. de C.V. Sales by retail concept during fiscal years 2006, 2005 and 2004 were as follows (in thousands):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Pier 1 Imports stores .....	\$1,720,899	\$1,782,351	\$1,771,644
Pier 1 Kids stores .....	34,251	25,705	19,320
Internet (including direct sales from catalog) .....	14,129	9,793	8,635
Other <sup>(1)</sup> .....	<u>7,422</u>	<u>7,494</u>	<u>6,493</u>
Net sales .....	<u>\$1,776,701</u>	<u>\$1,825,343</u>	<u>\$1,806,092</u>

<sup>(1)</sup> Other sales consisted of wholesale sales and royalties received from franchise stores and from Sears de Mexico S.A., and Pier 1 Kids' contract sales. As of August 2003, Pier 1 Kids discontinued sales of merchandise under wholesale contracts.

Net sales during fiscal 2006 were \$1,776.7 million, a decrease of \$48.6 million, or 2.7%, from \$1,825.3 million for the prior fiscal year. The decrease in sales for the fiscal year was comprised of the following components (in thousands):

	<u>2006</u>
New stores opened during fiscal 2006 .....	\$ 45,734
Stores opened during fiscal 2005 .....	58,975
Comparable stores .....	(114,771)
Closed stores and other .....	<u>(38,580)</u>
Net decrease in sales .....	<u>\$ (48,642)</u>

Comparable store sales for fiscal 2006 decreased 7.1% primarily as a result of decreased store traffic and increased competition from other retailers. Throughout the year, the Company has struggled to maintain and increase customer traffic, which the Company believes was the result of its inability to differentiate its merchandise from competitors through its marketing campaign. In an effort to encourage customers to return to the stores, the Company distributed its first two nation-wide catalogs. The first catalog was mailed in the fall and the second in the holiday season. The Company's net sales from Canada were subject to fluctuations in currency conversion rates. These fluctuations had an immaterial favorable impact on both total net sales and comparable store sales calculations in fiscal 2006 compared to fiscal 2005.

The Company opened 65 and closed 32 North American Pier 1 stores during fiscal 2006, bringing the Pier 1 store count to 1,183 at year end, compared to 1,150 last year. The Company also opened four and closed six Pier 1 Kids stores and opened one store and one "store within a store" in Mexico. Including all worldwide locations the Company's store count for continuing operations totaled 1,259 at the end of fiscal 2006, which represents an increase of 3.2% in total retail square footage compared to the end of last fiscal year. During fiscal 2007, the Company expects to open 40 new Pier 1 stores and close approximately 30 stores, close five Pier 1 Kids stores and open five stores in Mexico and two in Puerto Rico. A summary

reconciliation of the Company's stores open at the beginning of fiscal 2006, 2005 and 2004 to the number open at the end of each period follows (openings and closings include relocated stores):

	Pier 1 North American	International <sup>(1)</sup>	Pier 1 Kids	Continuing Operations	Discontinued Operations <sup>(2)</sup>	Total
Open at March 1, 2003 . . .	1,000	24	25	1,049	25	1,074
Openings . . . . .	120	3	22	145	4	149
Closings . . . . .	(37)	—	(7)	(44)	—	(44)
Open at February 28, 2004	1,083	27	40	1,150	29	1,179
Openings . . . . .	104	4	10	118	3	121
Closings . . . . .	(37)	—	(5)	(42)	—	(42)
Open at February 26, 2005	1,150	31	45	1,226	32	1,258
Openings . . . . .	65	2	4	71	15	86
Closings . . . . .	(32)	—	(6)	(38)	(2)	(40)
Open at February 25, 2006	<u>1,183</u>	<u>33</u>	<u>43</u>	<u>1,259</u>	<u>45</u>	<u>1,304</u>

<sup>(1)</sup> International stores were located in Puerto Rico and Mexico.

<sup>(2)</sup> Discontinued operations relate to The Pier (fiscal 2006 openings included 12 "store within a store" formats.)

The Company's proprietary credit card generated net sales of \$422.5 million, a decrease of \$38.7 million or 8.4% from last year's proprietary credit card sales of \$461.2 million. Sales on the proprietary credit card totaled 25.7% of United States store sales compared to 27.1% last year. Average ticket on the Company's proprietary credit card increased to \$163 during fiscal 2006 from \$159 during fiscal 2005. At the end of the second quarter of fiscal 2006, in an effort to stimulate sales on the proprietary credit card, the Company began offering a 12-month, no interest promotion on larger purchases as well as supporting special incentives for store associates to encourage customers to open new credit card accounts. While the proprietary credit card generates modest income, it primarily serves as a tool for marketing and communication to the Company's most loyal customers.

## Gross Profit

Gross profit after related buying and store occupancy costs, expressed as a percentage of sales, was 33.9% in fiscal 2006 compared to 38.5% a year ago. Merchandise margins, as a percentage of sales, declined from 53.1% in fiscal 2005 to 50.2% in fiscal 2006, a decrease of 290 basis points. The decline in merchandise margin rates resulted primarily from the Company's continued use of promotional discounts and clearance markdowns in an effort to stimulate sales as well as make way for new and unique merchandise lines. Store occupancy costs during fiscal 2006 were \$290.4 million or 16.3% of sales, an increase of \$24.1 million and 170 basis points over store occupancy costs of \$266.3 million or 14.6% of sales during fiscal 2005. This increase was primarily due to an inability to leverage relatively fixed rental costs over a lower sales base.

## Operating Expenses, Depreciation and Income Taxes

Selling, general and administrative expenses, including marketing, comprised 33.1% of sales in fiscal 2006, an increase of 300 basis points over last year's 30.1% of sales. In total dollars, selling, general and administrative expenses increased \$38.6 million in fiscal 2006 over fiscal 2005, with \$34.1 million of the increase attributable to expenses that normally vary with sales and number of new stores, such as marketing, store payroll, supplies, and equipment rental. These variable expenses increased 250 basis points as a percentage of sales for fiscal 2006 compared to fiscal 2005. Despite the negative comparable store sales for the year, the Company intentionally did not decrease store payroll hours in an effort to maintain minimum staffing levels and continue to provide good customer service. In addition, the Company was

unable to leverage certain fixed portions of store payroll costs over the lower sales base. In an effort to increase customer traffic to its stores, marketing expenditures during fiscal 2006 were planned to increase over fiscal 2005 and were up \$16.0 million to 5.8% of sales, an increase over fiscal 2005 of 105 basis points expressed as a percentage of sales. The Company had discontinued its television advertising campaign last year when viewed by management as ineffective at increasing customer traffic and driving sales. From October 2004 through February 2005, the Company had no television advertising. During fiscal 2006, the Company re-launched a national television advertising campaign and distributed two nation-wide catalogs while discontinuing its newspaper insert programs. The Company continually reassesses its advertising campaign's effectiveness and revises its plans based upon customer research and feedback. Store supplies and equipment rental increased \$2.6 million and 20 basis points as a percentage of sales.

Relatively fixed selling, general and administrative expenses increased \$4.6 million in fiscal 2006, or 50 basis points as a percentage of sales over last year. Other occupancy expenses (excluding store and distribution center occupancy expenses) increased \$4.9 million or 30 basis points, primarily as a result of impairment charges of \$5.8 million recognized on long-lived store-level assets, which related largely to the approximate 35 stores expected to close in fiscal 2007, compared to impairment charges in fiscal 2005 of \$0.4 million. In addition, the Company had a \$1.0 million write-off of the remaining balance of fixed assets and intangibles associated with early store closures in the current fiscal year. These non-cash charges were partially offset by a \$2.3 million savings in home office rental expense as the corporate headquarters were rented for a portion of fiscal 2005 but were owned for all of fiscal 2006. Lease accounting adjustments decreased \$6.6 million or 40 basis points as a percentage of sales from the prior year, primarily as a result of a cumulative correction of \$6.3 million recognized in the prior year related to pre-opening store rental expense for leases entered into in years prior to fiscal 2005. The Company's lease termination expense increased \$1.8 million or 10 basis points as a percentage of sales, primarily as a result of closing stores this year with longer remaining lease terms than those of the stores closed in the prior year. Typically, the Company closes stores upon lease expiration; however, due to the Company's thorough re-evaluation of individual store performance, more stores were closed prior to the lease expiration in an effort to improve the Company's overall real estate portfolio. Net proprietary credit card income increased \$4.0 million to \$7.2 million, representing a 20 basis point decrease in relatively fixed selling, general and administrative expenses as a percentage of sales. This increase in income was primarily the result of increased finance charge income, a decrease in processing charges and a decrease in bad debt expense. The increase in finance charge income was primarily a result of a modest increase in late payment fees and a reduction of the number of days in the grace period before interest charges are imposed. Non-store payroll increased \$8.9 million or 60 basis points as a percentage of sales for the year primarily as a result of a \$4.6 million increase in officers' retirement as well as planned payroll increases related to annual merit increases and long-term incentives. An additional \$0.7 million of severance costs related to field and home-office restructurings also contributed to the increase in non-store payroll. All other relatively fixed selling, general and administrative expenses decreased \$0.4 million and increased 10 basis points as a percentage of sales.

Depreciation and amortization for fiscal 2006 was \$56.2 million, representing an increase of approximately \$0.5 million over last year's depreciation and amortization expense of \$55.8 million. This increase was primarily the result of an increase in net new store openings, depreciation on software applications that were launched subsequent to the end of fiscal 2005 and a full year of depreciation on the Company's corporate headquarters in the current year versus a partial year last year. These increases were partially offset by a slight reduction in depreciation expense for certain assets that were fully depreciated during the year.

In fiscal 2006, the Company had an operating loss of \$42.8 million, a decline of \$141.1 million from the prior years' operating income of \$98.2 million.

The Company's effective tax rate was 34.5% of pretax income (loss) from continuing operations, compared to 36.7% in fiscal 2005 and 29.9% of pretax loss from discontinued operations. The decrease in the Company's effective tax rate from continuing operations was primarily the result of state tax liabilities.

## Net Loss

Net loss from continuing operations in fiscal 2006 was \$27.5 million or \$0.32 per share, a decrease of \$90.2 million as compared to fiscal 2005's net income from continuing operations of \$62.8 million, or \$0.71 per share on a diluted basis.

Net losses from discontinued operations were \$12.3 million or \$0.14 per share in fiscal 2006 and \$2.3 million or \$0.03 per share in fiscal 2005. The pre-tax loss of \$17.6 million was the result of The Pier's loss from operations of \$10.1 million and a \$7.4 million impairment charge to write the assets down to fair value less reasonable costs to sell. *See Note 3 of the Notes to Consolidated Financial Statements for additional information regarding discontinued operations.*

Total net loss in fiscal 2006 was \$39.8 million, or \$0.46 per share, a decrease in earnings of \$100.3 million as compared to fiscal 2005's net income of \$60.5 million, or \$0.68 per share on a diluted basis.

## FISCAL YEARS ENDED FEBRUARY 26, 2005 AND FEBRUARY 28, 2004

### Net Sales

Net sales consisted almost entirely of sales to retail customers, net of discounts and returns, but also included delivery service revenues and wholesale sales and royalties received from franchise stores and Sears Roebuck de Mexico, S.A. de C.V. Sales by retail concept during fiscal years 2005, 2004 and 2003 were as follows (in thousands):

	2005	2004	2003
Pier 1 Imports stores .....	\$1,782,351	\$1,771,644	\$1,677,050
Pier 1 Kids stores .....	25,705	19,320	12,199
Internet .....	9,793	8,635	6,380
Other <sup>(1)</sup> .....	7,494	6,493	7,768
Net sales .....	<u>\$1,825,343</u>	<u>\$1,806,092</u>	<u>\$1,703,397</u>

<sup>(1)</sup> Other sales consisted of wholesale sales and royalties received from franchise stores and from Sears de Mexico S.A., and Pier 1 Kids' contract sales. Also included in amounts from fiscal 2003 were Pier 1 Kids' dealer sales, which were discontinued in fiscal 2003. As of August 2003, Pier 1 Kids discontinued sales of merchandise under wholesale contracts.

During fiscal 2005, the Company recorded net sales of \$1,825.3 million, an increase of \$19.3 million or 1.1%, over net sales of \$1,806.1 million for fiscal year 2004. Incremental sales growth for fiscal 2005 was comprised of the following components (in thousands):

	2005
New stores opened during fiscal 2005 .....	\$89,044
Stores opened during fiscal 2004 .....	86,050
Comparable stores .....	(96,322)
Closed stores and other .....	<u>(59,521)</u>
Net incremental sales .....	<u>\$19,251</u>

Comparable store sales for fiscal 2005 decreased 6.1%. The Company believed that comparable store sales suffered as a result of a challenging retail environment with weakened discretionary spending among its target consumer group and increased competition from discount retailers. In addition to these external factors, the Company recognized the weak sales performance in fiscal 2005 was also attributable to an ineffective marketing campaign, merchandise assortment that lacked uniqueness and value, and stores that had become cluttered and difficult to shop. As a result of the above factors, the Company experienced



decreased customer traffic and conversion rates (transactions divided by traffic counts.) Management began to address these issues mid-way through fiscal 2005 by conducting a complete reassessment of the business and began to initiate strategic initiatives to focus on marketing, merchandising and store operations. The Company's net sales from Canada were subject to fluctuations in currency conversion rates. These fluctuations had an immaterial favorable impact on both total net sales and comparable store sales calculations during fiscal 2005.

Total net sales growth benefited from new store openings during fiscal 2005. The Company opened 104 and closed or relocated 37 North American Pier 1 stores during fiscal 2005, bringing the Pier 1 store count to 1,150 at year-end compared to 1,083 for fiscal 2004. The Company also opened 10 and closed five Pier 1 Kids stores and opened four locations with a "store within a store" format in Sears Roebuck de Mexico S.A. de C.V. Including all worldwide locations, the Company's store count for continuing operations totaled 1,226 at the end of fiscal 2005, which represented an increase of approximately 7.5% in total retail square footage compared to the end of fiscal 2004. A summary reconciliation of the Company's stores open at the beginning of fiscal 2005, 2004 and 2003 to the number open at the end of each period follows (openings and closings include relocated stores):

	Pier 1 North American	International <sup>(1)</sup>	Pier 1 Kids	Continuing Operations	Discontinued Operations <sup>(2)</sup>	Total
Open at March 2, 2002 ....	910	23	18	951	23	974
Openings .....	114	1	8	123	2	125
Closings .....	(24)	—	(1)	(25)	—	(25)
Open at March 1, 2003 ....	1,000	24	25	1,049	25	1,074
Openings .....	120	3	22	145	4	149
Closings .....	(37)	—	(7)	(44)	—	(44)
Open at February 28, 2004	1,083	27	40	1,150	29	1,179
Openings .....	104	4	10	118	3	121
Closings .....	(37)	—	(5)	(42)	—	(42)
Open at February 26, 2005	<u>1,150</u>	<u>31</u>	<u>45</u>	<u>1,226</u>	<u>32</u>	<u>1,258</u>

(1) International stores were located in Puerto Rico and Mexico.

(2) Discontinued operations relate to The Pier.

The Company's proprietary credit card generated net sales of \$461.2 million for fiscal 2005, an increase of \$24.4 million or 5.6% over fiscal 2004 proprietary credit card sales of \$436.8 million. Sales on the proprietary credit card were 27.1% for fiscal 2005 of United States store sales compared to 25.9% for fiscal 2004. Average ticket on the Company's proprietary credit card increased slightly to \$159 during fiscal 2005 from \$158 during fiscal 2004. The Company continued to try to increase total sales on its proprietary credit card by developing customer loyalty through marketing promotions targeted to cardholders, including deferred payment options on larger purchases. Although the proprietary credit card generated modest income, it primarily served as a tool for marketing and communication to the Company's most loyal customers.

## Gross Profit

Gross profit after related buying and store occupancy costs, expressed as a percentage of sales, was 38.5% during fiscal 2005, a decrease of 360 basis points compared to 42.1% in fiscal 2004. Merchandise margins as a percentage of sales declined 220 basis points from 55.3% in fiscal 2004 to 53.1% in fiscal 2005. Decreased merchandise margins were primarily the result of additional promotional discounts offered to customers in an attempt to stimulate sales. The Company also offered increased promotional discounts to reduce inventory levels in connection with planned efforts to reduce overall SKU counts and eliminate merchandise items that had been in the sales mix longer than a year. Store occupancy costs during fiscal

2005 increased 150 basis points to 14.6% of sales over 13.1% in fiscal 2004, primarily as a result of relatively fixed rental costs on a lower sales base and from an increase in the percentage of sales derived from newer and slightly larger stores for which occupancy costs as a percentage of sales tend to be higher until the stores reach maturity.

### **Operating Expenses, Depreciation and Income Taxes**

As a percentage of sales, selling, general and administrative expenses, including marketing, increased 100 basis points to 30.1% during fiscal 2005 over 29.1% of sales during fiscal 2004. In total dollars, selling, general and administrative expenses increased \$23.6 million in fiscal 2005 over fiscal 2004. During the fourth quarter of fiscal 2005, the Company revised its accounting practices for operating leases and leasehold improvements to reflect guidance expressed by the Office of the Chief Accountant of the Securities and Exchange Commission to the American Institute of Certified Public Accountants on February 7, 2005. As a result, the Company recorded a pre-tax charge of \$7.5 million ("lease accounting charge") to selling, general and administrative expenses for rent expense attributable to time periods prior to the opening of certain stores. Under this revision, these periods were deemed to constitute a free rent period that was considered in the straight-line rent expense calculation. Related rent should be charged to the income statement during the free rent period. This lease accounting charge included \$1.2 million related to leases entered into in fiscal 2005 and a cumulative charge of \$6.3 million for leases entered into in years prior to fiscal 2005, which was not material to the consolidated financial statements for any previously reported fiscal year. *See Note 1 of the Notes to Consolidated Financial Statements for additional information regarding the Company's lease accounting policies.*

Expenses that normally increase proportionately with sales and number of stores, such as marketing, store payroll, supplies and equipment rental, increased \$17.6 million and 80 basis points during fiscal 2005 as a percentage of sales over fiscal 2004. Store payroll including bonus increased \$17.1 million and 80 basis points as a percentage of sales as comparable store sales were insufficient to leverage store payroll costs arising from the need to maintain sufficient staffing levels to continue to provide an appropriate level of customer service, while transitioning inventories and changing store visual presentations. The Company's decision to discontinue television advertising and terminate its relationship with its previous agency reduced marketing expenses as a percentage of sales for the latter half of fiscal 2005, almost entirely offsetting higher expense as a percentage of sales through the second quarter of fiscal 2005. Compared to fiscal 2004, marketing expenses during fiscal 2005 decreased \$0.3 million and less than 10 basis points as a percentage of sales and represented 4.8% of sales for fiscal 2005 compared to 4.9% of sales for fiscal 2004. Other variable expenses, including supplies and equipment rental, increased \$0.8 million and were flat as a percentage of sales.

Relatively fixed selling, general and administrative expenses during fiscal 2005 increased \$6.0 million, or 25 basis points as a percentage of sales over fiscal 2004. The \$6.3 million cumulative impact of the lease accounting charge discussed above increased these expenses by 35 basis points as a percentage of sales. The fiscal 2005 effect of the lease accounting charge was \$1.2 million, increasing relatively fixed selling, general and administrative expenses by 10 basis points as a percentage of sales. Home office payroll increased \$4.6 million or 20 basis points as a percentage of sales, primarily as a result of annual merit increases and increases in the Company's expense related to retirement plans for officers and other employees. Partially offsetting these increases was a decrease of \$3.6 million or 20 basis points in settlements and bad debts primarily as a result of a non-recurring settlement in fiscal 2004 of a class action lawsuit regarding compensation matters for which the Company recorded a \$2.6 million charge. All other relatively fixed selling, general and administrative expenses decreased \$2.5 million or approximately 20 basis points as a percentage of sales.

Depreciation and amortization for fiscal 2005 was \$55.8 million, representing an increase of \$6.9 million over fiscal 2004 depreciation and amortization expense of \$48.9 million. This increase was primarily the result of net new store openings, depreciation on software applications that were launched subsequent to the end of fiscal 2004, and depreciation on the new corporate headquarters that began in

August 2004. These increases were partially offset by a reduction in depreciation expense for certain assets that were fully depreciated during fiscal 2005.

In fiscal 2005, operating income declined to \$98.2 million or 5.4% of sales from \$186.0 million or 10.3% of sales in fiscal 2004, a decrease of 47.2% or \$87.7 million.

The Company's effective tax rate for fiscal 2005 was 36.7% of income from continuing operations, a decrease from the fiscal 2004 effective tax rate of 37.1%.

### **Net Income**

Net income from continuing operations in fiscal 2005 was \$62.8 million or \$0.71 per share on a diluted basis, a decrease of \$54.9 million as compared to fiscal 2004's net income from continuing operations of \$117.7 million, or \$1.29 per share on a diluted basis.

Net loss from discontinued operations was \$2.3 million or \$0.03 per share, a decrease of \$2.6 million as compared to fiscal 2004's net income from discontinued operations of \$0.3 million or \$0.00 per share on a diluted basis.

Total net income in fiscal 2005 was \$60.5 million, or \$0.68 per share on a diluted basis, a decrease of \$57.5 million or 48.8% as compared to fiscal 2004's net income of \$118.0 million, or \$1.29 per share on a diluted basis. Net income decreased to 3.3% of sales in fiscal 2005 from 6.5% of sales in fiscal 2004.

### **LIQUIDITY AND CAPITAL RESOURCES**

For the purposes of liquidity and capital resource discussions, the Company's discontinued operations will be included in financial results. The Company's cash and cash equivalents including those from discontinued operations totaled \$253.2 million at the end of fiscal 2006, an increase of \$64.1 million over the fiscal 2005 year-end balance of \$189.1 million. Operating activities used \$64.3 million of cash primarily due to the exchange of proprietary credit card receivables for retained interests in securitized receivables which are non-monetary transactions in the operating section of the consolidated statements of cash flows. This exchange resulted in a decrease in cash provided by operating activities of \$74.6 million. Income tax receivable increased to \$18.0 million as a result of recording a federal income tax benefit related to the Company's net loss for the year and federal refund claims previously made. In addition, the Company's income tax payable (primarily related to state taxes and foreign taxes) decreased, using \$7.0 million during the year. Write-downs of assets held for sale related to the sale of The Pier resulted in a non-cash charge of \$7.4 million. Losses on impairment of fixed assets, also non-cash charges, were \$6.0 million, primarily attributable to the decision made by management to accelerate the closing of certain stores with weaker sales.

During fiscal 2006, investing activities by the Company provided a net \$10.4 million. Capital expenditures were \$51.0 million and consisted primarily of \$31.5 million for fixtures and leasehold improvements related to new and existing stores for Pier 1, The Pier, and Pier 1 Kids, \$15.8 million for information systems enhancements, and \$3.5 million in expenditures for the Company's distribution centers and infrastructure. The Company received \$1.4 million from the disposition of properties, primarily from the sale of one Company-owned store. Fiscal 2007 capital expenditures are projected to be approximately \$40 million.

A contribution of \$3.5 million was made during fiscal 2006 to the consolidated trust that was established for the purpose of setting aside funds to be used to settle pension obligations upon the retirement or death of certain of the Company's executive officers. The assets held by the trust are classified as restricted investments. The Company sold \$3.2 million of these restricted investments to settle pension obligations during fiscal 2006. At year end, the trust had a balance of \$22.4 million that may be used to pay future benefit payments. Future contributions to the trust may be made in the form of cash or other assets such as Company-owned life insurance policies. *See Note 11 of the Notes to Consolidated Financial Statements for additional information regarding the restricted assets and pension obligations.*

During fiscal 2006, the Company's collection of principal on beneficial interests in securitized receivables was \$60.2 million. The Company's beneficial interest in securitized receivables increased \$14.3 million to \$50.0 million from \$35.7 million at the end of fiscal 2005. This increase resulted primarily from an increase in the total proprietary credit card receivables portfolio of \$12.9 million from \$134.3 million at fiscal 2005 year-end to \$147.3 million at February 25, 2006. In addition to the increase in receivables was a \$1.4 million increase in cash held at the Master Trust at year-end over last year. The Company continued to have \$100 million of these beneficial interests held by outside parties, and all proprietary credit card receivables were securitized throughout fiscal 2006 and fiscal 2005. In prior years, the Company had classified the net change in its beneficial interest in the securitized receivables in the investing section of the consolidated statements of cash flows. In the fourth quarter of fiscal 2006, the Company concluded that it had not appropriately reflected the exchange of its proprietary credit card receivables for its retained interest in the securitized receivables as a non-monetary transaction. As a result, both cash provided by operating activities and cash used in investing activities were overstated in the consolidated statements of cash flows in each of the two years ended February 26, 2005. Accordingly, the Company has restated the fiscal 2005 and fiscal 2004 consolidated statements of cash flows. *See Note 4 of the Notes to Consolidated Financial Statements for additional information regarding the beneficial interest in securitized receivables and Note 2 for discussion of the restatement of the consolidated statements of cash flows.*

Fiscal 2006 financing activities provided a net \$118.0 million of the Company's cash. In February 2006, the Company issued \$165.0 million of 6.375% convertible senior notes due 2036 (the "Notes") in a private placement, and intends to register the Notes with the Securities and Exchange Commission by June 2006. The Company issued the Notes in order to maintain flexibility and provide additional liquidity and plans to utilize the proceeds for general corporate purposes. The Notes bear interest at a rate of 6.375% per year until February 15, 2011 and at a rate of 6.125% per year thereafter. Interest is payable semiannually in arrears on February 15 and August 15 of each year, commencing August 15, 2006. The Notes are convertible into cash and, if applicable, shares of the Company's common stock based on an initial conversion rate, subject to adjustments, of 65.8328 shares per \$1,000 principal amount of Notes (which represents an initial conversion price of approximately \$15.19 per share representing a 40% conversion premium). Holders of the Notes may convert their Notes only under the following circumstances: (1) during any fiscal quarter (and only during such fiscal quarter) commencing after May 27, 2006, if the last reported sale price of the Company's common stock is greater than or equal to 130% of the conversion price per share of common stock for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter; (2) if the Company has called the Notes for redemption; or (3) upon the occurrence of specified corporate transactions. In general, upon conversion of a Note, a holder will receive cash equal to the lesser of the principal amount of the Note or the conversion value of the Note and common stock of the Company for any conversion value in excess of the principal amount. The Company may redeem the Notes at its option on or after February 15, 2011 for cash at 100% of the principal amount. Additionally, the holders of the Notes may require the Company to purchase all or a portion of their Notes under certain circumstances, in each case at a repurchase price in cash equal to 100% of the principal amount of the repurchased Notes at February 15, 2011, February 15, 2016, February 15, 2021, February 15, 2026 and February 15, 2031, or if certain fundamental changes occur. The Notes are fully and unconditionally guaranteed, on a joint and several basis, by all of the Company's material domestic consolidated subsidiaries. As a result of the issuance of the Notes, the Company anticipates interest expense in fiscal 2007 to increase approximately \$6.0 million, net of forecasted interest income on the investment of the proceeds of the Notes. *See Note 10 of the Notes to Consolidated Financial Statements for additional information regarding the guarantors.*

In connection with the issuance of the Notes, the Company purchased a call option with respect to its common stock. If the call option, which expires February 15, 2011, is exercised by the Company, it must be net share settled and in all cases the Company would receive shares. This transaction has no effect on the terms of the Notes, but is intended to reduce the potential dilution upon future conversion of the Notes by effectively increasing the initial conversion price to \$17.09 per share, representing a 57.5% conversion premium. The call option is exercisable under the same circumstances which can trigger

conversion under the Notes. The net cost of \$9.1 million of the purchased call option was included in shareholders' equity, along with the partially offsetting \$3.4 million tax benefit of the call option.

In November 2005, the Company entered into a new \$325.0 million secured credit facility which matures in November 2010. This facility is secured by the Company's eligible merchandise inventory and third-party credit card receivables. It replaced the Company's previous unsecured bank facilities, including the three-year \$125.0 million revolving credit facility, the \$120.0 million uncommitted letter of credit facility, and other credit lines used for special-purpose letters of credit. The new facility initially bears interest at LIBOR plus 1.0% for cash borrowings. The Company will not be required to comply with financial covenants under the new facility unless the facility has less than \$32.5 million available under the borrowing base as defined in the agreement. As of February 25, 2006, the Company's borrowing base was \$221.5 million, of which \$127.1 million was available for cash borrowings. The Company pays a fee of 1.0% for standby letters of credit, 0.5% for trade letters of credit and a commitment fee of 0.25% for any unused amounts. The Company utilized its revolving credit facilities for cash borrowings from August 2005 to December 2005. The greatest amount of cash borrowings outstanding on the credit facilities at any one time was \$38.5 million. As of February 25, 2006, the Company had no outstanding cash borrowings and approximately \$94.5 million in letters of credit utilized against the new secured credit facility. Of the outstanding balance, approximately \$43.6 million related to trade letters of credit for merchandise purchases, \$29.0 million related to standby letters of credit for the Company's workers' compensation and general liability insurance policies, \$19.4 million related to standby letters of credit for the Company's industrial revenue bonds, and \$2.4 million related to other miscellaneous standby letters of credit.

The Company paid dividends totaling \$34.7 million during fiscal 2006. Subsequent to the end of fiscal 2006, the Company declared a quarterly cash dividend of \$0.10 per share payable on May 17, 2006, to shareholders of record on May 3, 2006. The Company may continue to pay cash dividends and repurchase its common stock in fiscal 2007, but expects to retain most of its future earnings for support and expansion of the Company's business. The Company's dividend policy will depend upon the earnings, financial condition and capital needs of the Company and other factors deemed relevant by the Company's Board of Directors. Under the Company's new credit facility, the Company would not be restricted from paying dividends unless the availability under the credit facility is less than 30% of the Company's borrowing base calculation.

During fiscal year 2006, the Company paid \$4.0 million to repurchase 250,000 shares of its common stock under the Board of Directors-approved stock buyback program at a weighted average price of \$16.19, including fees. As of April 24, 2006, approximately \$107.4 million remains available for share repurchases, which may be made in open market or private transactions from time to time depending on prevailing market conditions, the Company's available cash, and the Company's consideration of any loan agreement restrictions and its corporate credit ratings. The Company paid \$6.7 million in debt issuance costs and \$9.1 million related to the call option purchased in conjunction with the convertible debt offering discussed above. Other financing activities, primarily the exercise of stock options by employees, provided cash of \$7.6 million during fiscal 2006.

The Company's sources of working capital for fiscal 2006 were cash flows from investing activities, bank lines of credit and the issuance of convertible debt. The Company's secured credit facility may limit certain investments, and in some instances, limit the payment of dividends and repurchases of the Company's common stock. The Company was in compliance with all material debt covenants at fiscal 2006 year-end. The Company was granted a waiver by the lenders subsequent to year-end in connection with the restatement of the Company's consolidated statements of cash flows for fiscal 2005 and 2004.

From time to time, the Company purchases auction rate securities with the intention to hold them for short periods of time and considers them to be trading securities. Therefore, the cash flows from the purchases and sales of these securities are reported net in cash provided by operating activities. The Company had no auction rate securities outstanding at either February 25, 2006 or February 26, 2005.

The American Jobs Creation Act of 2004 (the "Jobs Act"), enacted on October 22, 2004, included a provision that encourages companies to reinvest foreign earnings in the United States by temporarily

permitting certain dividends received from controlled foreign subsidiaries to be eligible for an 85% dividends-received deduction. Numerous requirements must be satisfied for the repatriated earnings to qualify for the reduced rate of taxation. The one-year period during which the Company could make qualifying distributions was fiscal 2006. In September 2005, the Company finalized its evaluation of and the Company's Board of Directors approved the repatriation of \$25 million of foreign earnings under the provisions of the Jobs Act. The Company repatriated these earnings on September 30, 2005 with no material impact on the Company's effective tax rate.

A summary of the Company's contractual obligations and other commercial commitments as of February 25, 2006 is listed below (in thousands):

	Total	Amount of Commitment Per Period			
		Less Than 1 Year	1 to 3 Years	3 to 5 Years	More Than 5 Years
Operating leases .....	\$1,415,357	\$235,947	\$ 424,141	\$343,431	\$411,838
Purchase obligations <sup>(1)</sup> .....	285,290	285,290	—	—	—
Convertible debt <sup>(2)</sup> .....	165,000	—	—	165,000	—
Standby letters of credit <sup>(3)</sup> .....	31,432	31,432	—	—	—
Industrial revenue bonds .....	19,000	—	—	—	19,000
Interest on convertible debt <sup>(2)</sup> .....	52,594	10,519	21,038	21,037	—
Interest on industrial revenue bonds <sup>(4)</sup> ...	12,695	612	1,224	1,223	9,636
Interest and related fees on secured credit facility <sup>(5)</sup> .....	6,188	1,303	2,605	2,280	—
Other long-term obligations <sup>(6)</sup> .....	93,741	1,685	37,789	2,398	51,869
Total <sup>(7)</sup> .....	<u>\$2,081,297</u>	<u>\$566,788</u>	<u>\$ 486,797</u>	<u>\$535,369</u>	<u>\$492,343</u>
Liabilities recorded on the balance sheet .....			\$ 294,019		
Commitments not recorded on the balance sheet .....			<u>1,787,278</u>		
Total .....			<u>\$ 2,081,297</u>		

<sup>(1)</sup> As of February 25, 2006, the Company had approximately \$285.3 million of outstanding purchase orders, which were primarily related to merchandise inventory. Such orders are generally cancelable at the discretion of the Company until the order has been shipped. The table above excludes certain immaterial executory contracts for goods and services that tend to be recurring in nature and similar in amount year over year and includes \$43.6 million in merchandise letters of credit.

<sup>(2)</sup> The Company's convertible debt is subject to redemption in part or full on February 15, 2011, and the above amounts assume the Notes will be repaid at that time. If all Notes remain outstanding until maturity, the total interest paid would be \$305.3 million. *See Note 9 of the Notes to Consolidated Financial Statements for further discussion of the Company's convertible senior notes.*

<sup>(3)</sup> The Company also has outstanding standby letters of credit totaling \$19.4 million related to the Company's industrial revenue bonds. This amount is excluded from the table above as it is not incremental to the Company's total outstanding commitments.

<sup>(4)</sup> The interest rates on the Company's industrial revenue bonds are variable and reset weekly. The estimated interest payments included in the table were calculated based upon the rate in effect at fiscal 2006 year-end.

<sup>(5)</sup> Represents estimated commitment fees for trade and standby letters of credit, and unused fees on the Company's \$325 million secured credit facility, which expires in November 2010 and were calculated based upon balances and rates in effect at fiscal 2006 year-end.

- (6) Other long-term obligations represent the Company's liability under various unfunded retirement plans and certain deferred compensation agreements. *See Note 11 of the Notes to Consolidated Financial Statements for further discussion of the Company's employee benefit plans.*
- (7) The above amounts do not include payments that may be due under post-employment consulting agreements with certain employees. The terms and amounts under such agreements are disclosed in the Proxy Statement for the Company's 2006 Annual Meeting of Shareholders.

The present value of total existing minimum operating lease commitments discounted at 10% was \$978.6 million at fiscal 2006 year-end. The Company plans to fund these commitments from cash generated from the operations of the Company and from borrowings against lines of credit.

During fiscal 2007, the Company plans to open 40 new Pier 1 stores and close approximately 30 stores as leases expire or are otherwise ended. In addition, the Company plans to close five Pier 1 Kids stores. New store locations will be financed primarily through operating leases. Additionally, the Company began operating its new distribution center in Tacoma, Washington in March, 2006, which is leased under an operating lease. Total capital expenditures for fiscal 2007 are expected to be approximately \$40 million. Of this amount, the Company expects to spend approximately \$16 million on store development, \$16 million on information systems enhancements and approximately \$8 million primarily related to the Company's distribution centers.

In summary, the Company's primary uses of cash in fiscal 2006 were to fund operating expenses; provide for new and existing store development; fund capital additions related to distribution centers and information systems development; and pay dividends and repurchase common stock of the Company. Historically, the Company has financed its operations primarily from internally generated funds and borrowings under the Company's credit facilities. In recent months the Company has also received proceeds from a convertible debt offering and from the sale of its subsidiary, The Pier, and may also consider other strategic alternatives such as the sale of its credit card business. The Company believes that the funds provided from operations, available lines of credit, proceeds from the issuance of convertible debt and sales of its proprietary credit card receivables will be sufficient to finance working capital and capital expenditure requirements throughout fiscal year 2007.

#### **OFF-BALANCE SHEET ARRANGEMENTS**

Other than the operating leases and letters of credit discussed above, the Company's only other off-balance sheet arrangement relates to the securitization of the Company's proprietary credit card receivables. On a daily basis, the Company sells its proprietary credit card receivables that meet certain eligibility criteria to a special-purpose, wholly owned subsidiary, Pier 1 Funding, LLC ("Funding"), which transfers the receivables to Pier 1 Imports Credit Card Master Trust (the "Master Trust"). The Master Trust has issued \$100 million face amount of debt securities (the Class A Certificates) to a third party. This securitization of receivables provides the Company with a portion of its funding. However, neither Funding nor the Master Trust is consolidated in the Company's financial statements, and the Company has no obligation to reimburse Funding, the Master Trust or purchasers of Class A Certificates for credit losses from the receivables. During fiscal 2006, the Company's securitization agreements were amended to, among other things, extend the expiration date until September 2006 and to increase the amount of Class B Certificates required to be held by Funding for the benefit and protection of Class A Certificate holders from approximately \$9.3 million to approximately \$13.6 million if the Company's credit ratings fall below certain required minimums. The Company's credit rating fell below this minimum and in February, 2006, the Class B Certificates were increased to \$13.6 million raising the minimum amount of receivables necessary to avoid repayment of the Class A Certificates. Should the balance of the underlying credit card receivables held by the Master Trust decline to a level that the Class A Certificates become insufficiently collateralized, the Master Trust would be contractually required to repay a portion of the Class A Certificates from daily collections, thereby reducing funds available for purchases of newly generated proprietary credit card receivables. At the end of fiscal 2006, the underlying credit card receivables held by the Master Trust were \$147.3 million and would have had to fall below \$122.2 million before a repayment

would have been required. This repayment would only be to the extent necessary to maintain the required ratio of receivables to the Class A Certificates as set forth in the securitization agreement. In addition, the failure of the Master Trust to comply with its required performance measures, such as payment rate, dilution rate, portfolio yield and minimum transferor's interest; the failure of the Company to meet the minimum credit rating requirement; or other material adverse changes in the Company's credit quality, would trigger an early amortization event. Such an event would eliminate the securitization as a source of funding for the Company. The performance measures would have to deteriorate significantly from their current levels, or the credit rating would have to fall more than one notch to result in such an early amortization event. If either an early amortization event had occurred, or the Company had been required to consolidate the Master Trust due to a change in accounting rules, the Company's statement of operations for fiscal 2006 would not have been materially different from its reported results. An early amortization event would require the repayment of the Class A Certificates by the Master Trust, thereby reducing funds available for purchases of newly generated proprietary credit card receivables. The consolidation of the Master Trust would result in an increase of approximately \$100 million in both the Company's assets and liabilities as of February 25, 2006. *See Note 4 of the Notes to Consolidated Financial Statements for additional information regarding the beneficial interest in securitized receivables.*

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of the Company's consolidated financial statements in accordance with accounting principles generally accepted in the United States requires the use of estimates that affect the reported value of assets, liabilities, revenues and expenses. These estimates are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for the Company's conclusions. The Company continually evaluates the information used to make these estimates as the business and the economic environment changes. Historically, actual results have not varied materially from the Company's estimates, with the exception of impairments as discussed below, and the Company does not currently anticipate a significant change in its assumptions related to these estimates. Actual results may differ from these estimates under different assumptions or conditions. The Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements. The policies and estimates discussed below include the financial statement elements that are either judgmental or involve the selection or application of alternative accounting policies and are material to our financial statements. Unless specifically addressed below, the Company does not believe that its critical accounting policies are subject to market risk exposure that would be considered material and as a result, has not provided a sensitivity analysis. The use of estimates is pervasive throughout the consolidated financial statements, but the accounting policies and estimates considered most critical are as follows:

**Revenue recognition** — The Company recognizes revenue from retail sales, net of sales tax, upon customer receipt or delivery of merchandise, including sales under deferred payment promotions on its proprietary credit card. Typically, credit card receivable deferral programs offer deferred payments for up to 90 days or monthly installment payments over 12 months. Historically these payment deferral programs have not resulted in significant increases in bad debt losses arising from such receivables. The Company records an allowance for estimated merchandise returns based on historical experience and other known factors. Should actual returns differ from the Company's estimates and current provision for merchandise returns, revisions to the estimated merchandise returns may be required.

**Gift cards** — Revenue associated with gift cards is deferred until redemption of the gift card. Gift card breakage is estimated and recorded as income based upon an analysis of the Company's historical redemption patterns and represents the remaining unused portion of the gift card liability for which the likelihood of redemption is remote. If actual redemption patterns vary from the Company's estimates, actual gift card breakage may differ from the amounts recorded.

**Beneficial interest in securitized receivables** — The Company securitizes its entire portfolio of proprietary credit card receivables. During fiscal 2006, 2005 and 2004, the Company sold all of its proprietary credit card receivables, except an immaterial amount of those that failed certain eligibility



requirements, to a special-purpose wholly owned subsidiary, Pier 1 Funding, LLC ("Funding"), which transferred the receivables to the Pier 1 Imports Credit Card Master Trust (the "Master Trust"). Neither Funding nor the Master Trust is consolidated by the Company, and the Master Trust meets the requirements of a qualifying special-purpose entity under SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." The Master Trust issues beneficial interests that represent undivided interests in the assets of the Master Trust consisting of the transferred receivables and all cash flows from collections of such receivables. The beneficial interests include certain interests retained by Funding, which are represented by Class B Certificates, and the residual interest in the Master Trust (the excess of the principal amount of receivables held in the Master Trust over the portion represented by the certificates sold to third-party investors and the Class B Certificates). Gain or loss on the sale of receivables depends in part on the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests based on their relative fair value at the date of transfer.

The beneficial interest in the Master Trust is accounted for as an available-for-sale security and is recorded at fair value. The Company estimates fair value of its beneficial interest in the Master Trust, both upon initial securitization and thereafter, based on the present value of future expected cash flows using management's best estimates of key assumptions including credit losses and payment rates. As of February 25, 2006 and February 26, 2005, the Company's assumptions used to calculate the present value of the future cash flows included estimated credit losses of 4.75% and 5%, respectively, of the outstanding balance, expected payment within a six-month period and a discount rate representing the average market rate the Company would expect to pay if it sold securities representing ownership in the excess receivables not required to collateralize the Class A Certificates. A sensitivity analysis performed assuming a hypothetical 20% adverse change in both interest rates and credit losses resulted in an immaterial impact on the fair value of the Company's beneficial interest. Although not anticipated by the Company, a significant deterioration in the financial condition of the Company's credit card holders, interest rates or other economic conditions could result in other than temporary losses on the beneficial interest in future periods.

**Inventories** — The Company's inventory is comprised of finished merchandise and is stated at the lower of average cost or market, cost being determined on a weighted average inventory method. Cost is calculated based upon the actual landed cost of an item at the time it is received in the Company's warehouse using actual vendor invoices, the cost of warehousing and transporting product to the stores and other direct costs associated with purchasing products. Carrying values of inventory are analyzed and to the extent that the cost of inventory exceeds the expected selling prices less reasonable costs to sell, provisions are made to reduce the carrying amount of the inventory. The Company reviews its inventory levels in order to identify slow-moving merchandise and uses merchandise markdowns to sell such merchandise. Markdowns are recorded to reduce the retail price of such slow-moving merchandise as needed. Since the determination of carrying values of inventory involves both estimation and judgment with regard to market values and reasonable costs to sell, differences in these estimates could result in ultimate valuations that differ from the recorded asset.

The Company recognizes known inventory losses, shortages and damages when incurred and makes a provision for estimated shrinkage. The amount of the provision is estimated based on historical experience from the results of its physical inventories. Inventory is physically counted at substantially all locations at least once in each 12-month period, at which time actual results are reflected in the financial statements. Physical counts were taken at substantially all stores and distribution centers during fiscal 2006. Although inventory shrink rates have not fluctuated significantly in recent years, should actual rates differ from the Company's estimates, revisions to the inventory shrink expense may be required. Most inventory purchases and commitments are made in United States dollars.

**Impairment of long-lived assets** — Long-lived assets such as buildings, equipment, furniture and fixtures, and leasehold improvements are reviewed at the store level for impairment at least annually and whenever an event or change in circumstances indicates that its carrying value may not be recoverable. If the carrying value exceeds the sum of the expected undiscounted cash flows, the asset is impaired.

Expected cash flows are estimated based on management's estimate of changes in sales, merchandise margins, and expenses over the remaining expected terms of the leases. Impairment is measured as the amount by which the carrying value of the asset exceeds the fair value of the asset. Fair value is determined by discounting expected cash flows. Impairment, if any, is recorded in the period in which the impairment occurred and the Company recorded \$5.6 million in impairment charges in fiscal 2006. As the projection of future cash flows requires the use of judgment and estimates, if actual results differ from the Company's estimates, additional charges for asset impairments may be recorded in the future.

**Insurance provision** — The Company is self-insured with respect to medical coverage offered to eligible employees except that claims in excess of \$150,000 per occurrence per year are covered by a purchased insurance policy. The Company records a provision for estimated claims that have been incurred but not reported. Such claim amounts are estimated based on historical average claims per covered individual per month and on the average historical lag time between the covered event and the time it is paid by the Company. The liability for estimated medical claims incurred but not reported at February 25, 2006 was \$3.6 million.

During fiscal 2006, the Company maintained insurance for workers' compensation and general liability claims with a deductible of \$1,000,000 and \$750,000, respectively, per claim. The liability recorded for such claims is determined by estimating the total future claims cost for events that occurred prior to the balance sheet date. The estimates consider historical claims development factors as well as information obtained from and projections made by the Company's insurance carrier and underwriters. The recorded liabilities for workers' compensation and general liability claims at February 25, 2006 were \$14.5 million and \$4.9 million, respectively.

The assumptions made in determining the above estimates are reviewed continually and the liability adjusted accordingly as new facts are revealed. Changes in circumstances and conditions affecting the assumptions used in determining the liabilities could cause actual results to differ from the Company's recorded amounts.

**Pension costs** — The Company maintains supplemental retirement plans (the "Plans") for certain of its executive officers. The Plans provide that upon death, disability or reaching retirement age, a participant will receive benefits based on highest compensation and years of service. These benefit costs are dependent upon numerous factors, assumptions and estimates. Benefit costs may be significantly affected by changes in key actuarial assumptions such as the discount rate, compensation rates, or retirement dates used to determine the projected benefit obligation. Additionally, changes made to the provisions of the Plans may impact current and future benefit costs.

**Income taxes** — The Company records income tax expense using the liability method for taxes. The Company is subject to income tax in many jurisdictions, including the United States, various states and localities, and foreign countries. At any point in time, multiple tax years are subject to audit by various jurisdictions and the Company records reserves for estimates of probable tax exposures of foreign and domestic tax audits. The results and timing of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. The process of determining tax expense by jurisdiction involves the calculation of actual current tax expense or benefit, together with the assessment of deferred tax expense resulting from differing treatment of items for tax and financial accounting purposes. Deferred tax assets and liabilities are recorded in the Company's consolidated balance sheets and are classified as current or noncurrent based on the classification of the related assets or liabilities for financial reporting purposes. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not that such assets will be realized. If different assumptions had been used, the Company's tax expense or benefit, assets and liabilities could have varied from recorded amounts. If actual results differ from estimated results or if the Company adjusts these assumptions in the future, the Company may need to adjust its deferred tax assets or liabilities, which could impact its effective tax rate. The Company is relying on future taxable income to utilize the majority of the net deferred tax asset of \$24,715,000. Based upon the Company's earnings history, its earnings projections and length of time within which to utilize the asset (the tax loss carryforward period of 20 years,) management believes it is more

likely than not that the tax benefits of the asset will be realized. Accordingly, no valuation allowance has been provided on deferred taxes related to continuing operations.

## **IMPACT OF INFLATION AND CHANGING PRICES**

Inflation has not had a significant impact on the operations of the Company during the preceding three years.

## **IMPACT OF NEW ACCOUNTING STANDARDS**

In December 2004, the Financial Accounting Standards Board (the "FASB") issued SFAS No. 123 (Revised 2004), "Share-Based Payment" ("SFAS 123R"). This statement replaces FASB Statement No. 123, "Accounting for Stock-Based Compensation," and supercedes Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R requires all companies to measure compensation cost for all share-based payments, including stock options, at fair value. The statement will be effective for public companies no later than the beginning of the first fiscal year commencing after June 15, 2005, which for the Company is the beginning of fiscal 2007. In March 2005, the Securities and Exchange Commission (the "SEC") issued Staff Accounting Bulletin No. 107, "Share-Based Payment" ("SAB 107"). SAB 107 summarizes the views of the SEC staff regarding the interaction between SFAS 123R and certain SEC rules and regulations, and is intended to assist in the initial implementation of SFAS 123R. The Company will adopt SFAS 123R using the modified prospective method and is currently evaluating the effect that SFAS 123R and SAB 107 will have on its consolidated balance sheets and its statements of shareholders' equity and cash flows. The Company estimates equity compensation costs to be in the range of \$2.5 million to \$5.6 million for fiscal 2007 depending on the timing and number of stock options and restricted shares granted during fiscal 2007. SFAS 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated, because they depend on, among other things, when employees exercise stock options. However, the amounts of operating cash flows recognized for such excess tax deductions for the years ended February 25, 2006, February 26, 2005 and February 28, 2004 were not material.

In March 2005, the FASB issued FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"), which is an interpretation of SFAS No. 143, "Accounting for Asset Retirement Obligations." FIN 47 clarifies terminology within SFAS No. 143 and requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. The adoption of FIN 47 did not have a material impact on the Company's consolidated balance sheets or statements of operations, shareholders' equity and cash flows.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"). SFAS 154 replaces APB No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements" and establishes retrospective application as the required method for reporting a change in accounting principle. SFAS 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The reporting of a correction of an error by restating previously issued financial statements is also addressed. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. SFAS 154 will have no impact on the Company's consolidated balance sheets and statements of operations, shareholders' equity and cash flows unless at a future date the Company has a change in accounting principle or correction of an error.

In June 2005, the FASB's Emerging Issues Task Force reached a consensus on Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements" ("EITF 05-6"). This guidance

requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. This guidance was effective for interim reporting periods beginning after June 29, 2005, and is applicable only to leasehold improvements that are purchased or acquired in reporting periods beginning after the effective date. The adoption of EITF 05-6 did not have an impact on the Company's consolidated balance sheets and statements of operations, shareholders' equity and cash flows.

In October 2005, the FASB issued FASB Staff Position No. FAS 13-1, "Accounting for Rental Costs Incurred during a Construction Period" ("FSP 13-1"). The guidance requires rental costs for operating leases during the construction period to be recognized as rental expense. The guidance permits either retroactive or prospective treatment for periods beginning after December 15, 2005. The Company currently complies with this guidance and, therefore, the application of FSP 13-1 is not expected to have a material effect on the Company's consolidated balance sheets and statements of operations, shareholders' equity and cash flows.

#### **Item 7A. Quantitative and Qualitative Disclosures about Market Risk.**

Market risks relating to the Company's operations result primarily from changes in foreign exchange rates and interest rates. The Company has only limited involvement with derivative financial instruments, does not use them for trading purposes and is not a party to any leveraged derivatives. Collectively, the Company's exposure to market risk factors is not significant and has not materially changed from February 26, 2005.

#### **Foreign Currency Risk**

The Company periodically enters into forward foreign currency exchange contracts. The Company uses such contracts to hedge exposures to changes in foreign currency exchange rates associated with purchases denominated in foreign currencies, primarily euros. The Company also uses contracts to hedge its exposure associated with repatriation of funds from its Canadian operations. Changes in the fair value of the derivatives are included in the Company's consolidated statements of operations as such contracts are not designated as hedges under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." Forward contracts that hedge merchandise purchases generally have maturities not exceeding six months. Changes in the fair value and settlement of these forwards are included in cost of sales. Contracts which hedge the repatriation of Canadian funds have maturities not exceeding 18 months and changes in the fair value and settlement of these contracts are included in selling, general and administrative expenses. At February 25, 2006, there were no outstanding contracts to hedge exposure associated with the Company's merchandise purchases denominated in foreign currencies or the repatriation of Canadian funds.

#### **Interest Rate Risk**

The Company manages its exposure to changes in interest rates by optimizing the use of variable and fixed rate debt. The interest rate exposure on the Company's secured credit facility and industrial revenue bonds is based upon variable interest rates and therefore is affected by changes in market interest rates. As of February 25, 2006, the Company had \$19.0 million in borrowings outstanding on its industrial revenue bonds and no cash borrowings outstanding on its secured credit facility. A hypothetical 10% adverse change in the interest rates applicable to either or both of these variable rate instruments would have a negligible impact on the Company's earnings and cash flows.

Additionally, the Company has \$165.0 million in convertible senior notes, which mature in February 2036. The notes pay a fixed annual rate of 6.375% for the first five years and a fixed rate of 6.125% thereafter. Changes in market interest rates generally affect the fair value of fixed rate debt instruments, but would not affect the Company's financial position, results of operations or cash flows related to these notes.

**Item 8. Financial Statements and Supplementary Data.**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors of Pier 1 Imports, Inc.

We have audited the accompanying consolidated balance sheets of Pier 1 Imports, Inc. as of February 25, 2006 and February 26, 2005, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended February 25, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Pier 1 Imports, Inc. at February 25, 2006 and February 26, 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended February 25, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 of the Notes to Consolidated Financial Statements, the Company corrected its classification of non-monetary transactions related to its beneficial interest in securitized receivables on the consolidated statements of cash flows. The prior periods presented have been restated for this correction.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Pier 1 Imports, Inc.'s internal control over financial reporting as of February 25, 2006, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 25, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Fort Worth, Texas  
April 25, 2006

**Pier 1 Imports, Inc.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands except per share amounts)

	Year Ended		
	2006	2005	2004
Net sales .....	\$1,776,701	\$1,825,343	\$1,806,092
Operating costs and expenses:			
Cost of sales (including buying and store occupancy costs) ....	1,175,011	1,121,697	1,045,180
Selling, general and administrative expenses .....	588,273	549,635	526,060
Depreciation and amortization .....	56,229	55,762	48,869
	<u>1,819,513</u>	<u>1,727,094</u>	<u>1,620,109</u>
Operating income (loss) .....	(42,812)	98,249	185,983
Nonoperating (income) and expenses:			
Interest and investment income .....	(3,510)	(2,635)	(2,724)
Interest expense .....	2,610	1,735	1,688
	<u>(900)</u>	<u>(900)</u>	<u>(1,036)</u>
Income (loss) from continuing operations before income taxes ...	(41,912)	99,149	187,019
Provision (benefit) for income taxes .....	(14,441)	36,384	69,315
Income (loss) from continuing operations .....	<u>(27,471)</u>	<u>62,765</u>	<u>117,704</u>
Discontinued operations:			
Income (loss) from discontinued operations (including write down of assets held for sale of \$7,441 in 2006) .....	(17,583)	(2,308)	297
Income tax benefit .....	(5,250)	—	—
Income (loss) from discontinued operations .....	<u>(12,333)</u>	<u>(2,308)</u>	<u>297</u>
Net income (loss) .....	<u>\$ (39,804)</u>	<u>\$ 60,457</u>	<u>\$ 118,001</u>
Earnings (loss) per share from continuing operations:			
Basic .....	<u>\$ (.32)</u>	<u>\$ .72</u>	<u>\$ 1.32</u>
Diluted .....	<u>\$ (.32)</u>	<u>\$ .71</u>	<u>\$ 1.29</u>
Earnings (loss) per share from discontinued operations:			
Basic .....	<u>\$ (.14)</u>	<u>\$ (.03)</u>	<u>\$ .00</u>
Diluted .....	<u>\$ (.14)</u>	<u>\$ (.03)</u>	<u>\$ .00</u>
Earnings (loss) per share:			
Basic .....	<u>\$ (.46)</u>	<u>\$ .69</u>	<u>\$ 1.32</u>
Diluted .....	<u>\$ (.46)</u>	<u>\$ .68</u>	<u>\$ 1.29</u>
Dividends declared per share: .....	<u>\$ .40</u>	<u>\$ .40</u>	<u>\$ .30</u>
Average shares outstanding during period:			
Basic .....	<u>86,629</u>	<u>87,037</u>	<u>89,294</u>
Diluted .....	<u>86,629</u>	<u>88,838</u>	<u>91,624</u>

The accompanying notes are an integral part of these financial statements.

**Pier 1 Imports, Inc.**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands except share amounts)

	<u>2006</u>	<u>2005</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents, including temporary investments of \$238,463 and \$178,289, respectively .....	\$ 246,115	\$ 185,722
Beneficial interest in securitized receivables .....	50,000	35,690
Other accounts receivable, net of allowance for doubtful accounts of \$1,119 and \$82, respectively .....	13,916	11,089
Inventories .....	368,978	365,767
Income tax receivable .....	18,011	—
Assets held for sale .....	32,359	39,815
Prepaid expenses and other current assets .....	<u>45,544</u>	<u>40,864</u>
Total current assets .....	774,923	678,947
Properties, net .....	298,922	320,138
Other noncurrent assets .....	<u>96,016</u>	<u>76,664</u>
	<u><u>\$1,169,861</u></u>	<u><u>\$1,075,749</u></u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable .....	\$ 105,916	\$ 108,132
Gift cards and other deferred revenue .....	63,835	60,844
Accrued income taxes payable .....	4,763	11,716
Liabilities related to assets held for sale .....	16,841	15,163
Other accrued liabilities .....	<u>97,493</u>	<u>95,723</u>
Total current liabilities .....	288,848	291,578
Long-term debt .....	184,000	19,000
Other noncurrent liabilities .....	107,031	100,802
Shareholders' equity:		
Common stock, \$1.00 par, 500,000,000 shares authorized, 100,779,000 issued .....	100,779	100,779
Paid-in capital .....	132,075	141,850
Retained earnings .....	582,221	656,692
Cumulative other comprehensive loss .....	(583)	(1,426)
Less — 13,761,000 and 14,459,000 common shares in treasury, at cost, respectively .....	(222,254)	(233,526)
Less — unearned compensation .....	<u>(2,256)</u>	<u>—</u>
	589,982	664,369
Commitments and contingencies .....	<u>—</u>	<u>—</u>
	<u><u>\$1,169,861</u></u>	<u><u>\$1,075,749</u></u>

The accompanying notes are an integral part of these financial statements.

**Pier 1 Imports, Inc.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	Year Ended		
	2006	2005	2004
		(As restated, See Note 2)	(As restated, See Note 2)
Cash flow from operating activities:			
Net income (loss) .....	\$(39,804)	\$ 60,457	\$118,001
Adjustments to reconcile to net cash (used in) provided by operating activities:			
Depreciation and amortization .....	78,781	75,624	64,606
Loss (gain) on disposal of fixed assets .....	1,781	315	(316)
Loss on impairment of fixed assets .....	6,024	741	459
Write-down of assets held for sale .....	7,441	—	—
Deferred compensation .....	11,402	7,710	6,573
Lease termination expense .....	4,176	2,243	3,258
Deferred income taxes .....	(14,496)	2,035	184
Sale of receivables in exchange for beneficial interest in securitized receivables .....	(74,550)	(91,071)	(83,931)
Tax benefit from options exercised by employees .....	760	3,668	4,897
Other .....	(524)	(222)	4,894
Change in cash from:			
Inventories .....	882	(6,860)	(40,520)
Other accounts receivable, prepaid expenses and other current assets ..	(22,778)	(11,302)	(16,927)
Income tax receivable .....	(18,011)	—	—
Accounts payable and accrued expenses .....	7,369	21,572	34,410
Income taxes payable .....	(6,966)	(14,116)	184
Other noncurrent assets .....	(2,558)	336	(2,027)
Other noncurrent liabilities .....	(3,226)	—	—
Net cash (used in) provided by operating activities .....	(64,297)	51,130	93,745
Cash flow from investing activities:			
Capital expenditures .....	(50,979)	(99,239)	(121,190)
Proceeds from disposition of properties .....	1,401	3,852	34,450
Proceeds from sale of restricted investments .....	3,226	—	—
Purchase of restricted investments .....	(3,500)	(10,807)	(8,752)
Collections of principal on beneficial interest in securitized receivables ...	60,240	99,712	78,788
Net cash provided by (used in) investing activities .....	10,388	(6,482)	(16,704)
Cash flow from financing activities:			
Cash dividends .....	(34,667)	(34,762)	(26,780)
Purchases of treasury stock .....	(4,047)	(58,210)	(76,009)
Proceeds from stock options exercised, stock purchase plan and other, net	7,641	12,473	15,709
Issuance of long-term debt .....	165,000	—	—
Notes payable borrowings .....	86,500	—	—
Repayment of notes payable .....	(86,500)	—	(6,390)
Debt issuance costs .....	(6,739)	(169)	(584)
Purchase of call option .....	(9,145)	—	—
Net cash provided by (used in) financing activities .....	118,043	(80,668)	(94,054)
Change in cash and cash equivalents .....	64,134	(36,020)	(17,013)
Cash and cash equivalents at beginning period (including cash held for sale of \$3,359, \$6,148 and \$6,506, respectively) .....	189,081	225,101	242,114
Cash and cash equivalents at end of period (including cash held for sale of \$7,100, \$3,359 and \$6,148, respectively) .....	<u>\$253,215</u>	<u>\$189,081</u>	<u>\$225,101</u>
Supplemental cash flow information:			
Interest paid .....	<u>\$ 8,136</u>	<u>\$ 868</u>	<u>\$ 1,791</u>
Income taxes paid .....	<u>\$ 21,342</u>	<u>\$ 45,655</u>	<u>\$ 63,788</u>

The accompanying notes are an integral part of these financial statements.



Pier 1 Imports, Inc.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
(In thousands except per share amounts)

	Common Stock		Paid-in Capital	Retained Earnings	Cumulative Other Comprehensive Income (Loss)	Treasury Stock	Unearned Compensation	Total Shareholders' Equity
	Outstanding Shares	Amount						
Balance March 1, 2003 .....	90,685	\$100,779	\$144,247	\$539,776	\$(2,210)	\$(138,656)	\$ —	\$643,936
Comprehensive income:								
Net income .....	—	—	—	118,001	—	—	—	118,001
Other comprehensive income:								
Minimum pension liability adjustments, net of tax ....	—	—	—	—	(1,033)	—	—	(1,033)
Currency translation adjustments .....	—	—	—	—	4,910	—	—	4,910
Comprehensive income .....								121,878
Purchases of treasury stock .....	(3,758)	—	—	—	—	(76,009)	—	(76,009)
Exercise of stock options, stock purchase plan and other .....	1,300	—	1,137	—	—	19,469	—	20,606
Cash dividends (\$.30 per share) ..	—	—	—	(26,780)	—	—	—	(26,780)
Balance February 28, 2004 .....	88,227	100,779	145,384	630,997	1,667	(195,196)	—	683,631
Comprehensive income:								
Net income .....	—	—	—	60,457	—	—	—	60,457
Other comprehensive income (loss), net of tax:								
Minimum pension liability adjustments .....	—	—	—	—	(4,780)	—	—	(4,780)
Currency translation adjustments .....	—	—	—	—	1,687	—	—	1,687
Comprehensive income .....								57,364
Purchases of treasury stock .....	(3,225)	—	—	—	—	(58,210)	—	(58,210)
Exercise of stock options, stock purchase plan and other .....	1,238	—	(3,534)	—	—	19,880	—	16,346
Cash dividends (\$.40 per share) ..	—	—	—	(34,762)	—	—	—	(34,762)
Balance February 26, 2005 .....	86,240	100,779	141,850	656,692	(1,426)	(233,526)	—	664,369
Comprehensive income (loss):								
Net loss .....	—	—	—	(39,804)	—	—	—	(39,804)
Other comprehensive income (loss), net of tax:								
Minimum pension liability adjustments .....	—	—	—	—	1,149	—	—	1,149
Currency translation adjustments .....	—	—	—	—	(306)	—	—	(306)
Comprehensive loss .....								(38,961)
Purchases of treasury stock .....	(250)	—	—	—	—	(4,047)	—	(4,047)
Restricted stock grant and amortization .....	203	—	(386)	—	—	3,278	(2,256)	636
Exercise of stock options, stock purchase plan and other .....	746	—	(3,640)	—	—	12,041	—	8,401
Cash dividends (\$.40 per share) ..	—	—	—	(34,667)	—	—	—	(34,667)
Purchase of call option, net of tax ..	—	—	(5,749)	—	—	—	—	(5,749)
Balance February 25, 2006 .....	86,939	\$100,779	\$132,075	\$582,221	\$(583)	\$(222,254)	\$(2,256)	\$589,982

The accompanying notes are an integral part of these financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Organization** — Pier 1 Imports, Inc. and its consolidated subsidiaries (the “Company”) is one of North America’s largest specialty retailers of imported decorative home furnishings, gifts and related items, with retail stores located primarily in the United States, Canada, Puerto Rico and Mexico. On March 20, 2006, the Company sold its subsidiary based in the United Kingdom, The Pier Retail Group Limited (“The Pier”). At fiscal 2006 year end, The Pier was classified as held for sale and included in discontinued operations for all years presented. In the fourth quarter of fiscal 2006, the Company recorded an impairment charge of \$7,441,000 to write goodwill and long-lived assets related to The Pier down by \$918,000 and \$6,523,000, respectively, to fair value less selling costs. *See Note 3 of the Notes to Consolidated Financial Statements for further discussion.*

**Basis of consolidation** — The consolidated financial statements of the Company include the accounts of all subsidiary companies except Pier 1 Funding, LLC, which is a non-consolidated, bankruptcy remote, securitization subsidiary. *See Note 4 of the Notes to Consolidated Financial Statements.* Material intercompany transactions and balances have been eliminated.

**Segment information** — The Company is a specialty retailer that offers a broad range of products in its stores and conducts business as one operating segment. The Company’s domestic operations provided 93.0%, 93.7% and 94.1% of its net sales, with 6.7%, 6.0% and 5.7% provided by stores in Canada, and the remainder from royalties received from Sears Roebuck de Mexico S.A. de C.V. during fiscal 2006, 2005 and 2004, respectively. As of February 25, 2006 and February 26, 2005, \$8,765,000 and \$8,888,000, respectively, of the Company’s long-lived assets were located in Canada. There were no long-lived assets in Mexico during either period.

**Use of estimates** — Preparation of the financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**Reclassifications** — Certain reclassifications have been made in the prior years’ consolidated financial statements to conform to the fiscal 2006 presentation. These reclassifications had no effect on net income and shareholders’ equity with minimal effects on total assets and total liabilities. During the fourth quarter of fiscal 2006, the Company determined that a reclassification within its consolidated statements of cash flows was required to properly reflect the exchanges of securitized receivables as non-monetary transactions in the operating activities section of the Company’s consolidated statements of cash flows. This reclass required a restatement for fiscal years 2005 and 2004. *See Note 2 of the Notes to Consolidated Financial Statements for further discussion.*

**Fiscal periods** — The Company utilizes 5-4-4 (week) quarterly accounting periods with the fiscal year ending on the Saturday nearest the last day of February. Fiscal 2006 ended February 25, 2006, fiscal 2005 ended February 26, 2005 and fiscal 2004 ended February 28, 2004, all of which contained 52 weeks.

**Cash and cash equivalents** — The Company considers all highly liquid investments with an original maturity date of three months or less to be cash equivalents, except for those investments that are restricted and have been set aside in a trust to satisfy pension obligations. As of February 25, 2006 and February 26, 2005, the Company’s short-term investments classified as cash equivalents included investments in money market mutual funds totaling \$238,463,000 and \$178,289,000, respectively. The effect of foreign currency exchange rate fluctuations on cash is not material.

**Translation of foreign currencies** — Assets and liabilities of foreign operations are translated into United States dollars at fiscal year-end exchange rates. Income and expense items are translated at average exchange rates prevailing during the year. Translation adjustments arising from differences in exchange rates from period to period are included as a separate component of shareholders’ equity and are included in other comprehensive income (loss). As of February 25, 2006, February 26, 2005 and

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

February 28, 2004, the Company had cumulative other comprehensive income balances of \$4,990,000, \$5,296,000, and \$3,609,000, respectively, related to cumulative translation adjustments. The adjustments for currency translation during fiscal 2006, 2005 and 2004 resulted in other comprehensive income (loss) of (\$306,000), \$1,687,000, and \$4,910,000, respectively. During fiscal 2006 and 2005, the Company provided deferred taxes of \$531,000 and \$703,000, respectively, on the portion of its cumulative currency translation adjustment considered not to be permanently reinvested abroad. Taxes on this portion of cumulative currency translation adjustments were insignificant in fiscal 2004.

**Concentrations of risk** — The Company has some degree of risk concentration with respect to sourcing the Company's inventory purchases. However, the Company believes alternative sources of products could be procured over a relatively short period of time. Pier 1 sells merchandise imported from over 40 different countries, with 35% of its sales derived from merchandise produced in China, 14% derived from merchandise produced in India, 13% derived from merchandise produced in the United States and 33% derived from merchandise produced in Indonesia, Brazil, Italy, Thailand, the Philippines, Vietnam and Mexico. The remaining 5% of sales was from merchandise produced in various Asian, European, Central American, South American and African countries.

**Financial instruments** — The fair value of financial instruments is determined by reference to various market data and other valuation techniques as appropriate. There were no assets or liabilities with a fair value significantly different from the recorded value as of February 25, 2006 and February 26, 2005.

From time to time, the Company purchases auction rate securities with the intention to hold them for short periods of time and considers them to be trading securities. The cash flows from the purchases and sales of these securities are reported in cash provided by operating activities. The Company had no auction rate securities outstanding at either February 25, 2006 or February 26, 2005.

**Risk management instruments:** The Company may utilize various financial instruments to manage interest rate and market risk associated with its on- and off-balance sheet commitments.

The Company hedges certain commitments denominated in foreign currencies through the purchase of forward contracts. The forward contracts are purchased only to cover specific commitments to buy merchandise for resale. The Company also uses contracts to hedge its exposure associated with the repatriation of funds from its Canadian operations. At February 25, 2006, there were no outstanding contracts to hedge exposure associated with the Company's merchandise purchases denominated in foreign currencies or the repatriation of Canadian funds. For financial accounting purposes, the Company does not designate such contracts as hedges. Thus, changes in the fair value of both types of forward contracts would be included in the Company's consolidated statements of operations. Both the changes in fair value and settlement of these contracts are included in cost of sales for forwards related to merchandise purchases and in selling, general and administrative expense for the contracts associated with the repatriation of Canadian funds.

The Company enters into forward foreign currency exchange contracts with major financial institutions and continually monitors its positions with, and the credit quality of, these counterparties to such financial instruments. The Company does not expect non-performance by any of the counterparties, and any losses incurred in the event of non-performance would not be material.

**Beneficial interest in securitized receivables** — The Company securitizes its entire portfolio of proprietary credit card receivables. During fiscal 2006, 2005 and 2004, the Company sold all of its proprietary credit card receivables, except those that failed certain eligibility requirements, to a special-purpose wholly owned subsidiary, Pier 1 Funding, LLC ("Funding"), which transferred the receivables to the Pier 1 Imports Credit Card Master Trust (the "Master Trust"). Neither Funding nor the Master Trust is consolidated by the Company and the Master Trust meets the requirements of a qualifying special-purpose entity under Statement of Financial Accounting Standards ("SFAS") No. 140. The Master Trust issues beneficial interests that represent undivided interests in the assets of the Master Trust consisting of

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

the transferred receivables and all cash flows from collections of such receivables. The beneficial interests include certain interests retained by Funding, which are represented by Class B Certificates, and the residual interest in the Master Trust (the excess of the principal amount of receivables held in the Master Trust over the portion represented by the certificates sold to a third-party investor and the Class B Certificates). Gain or loss on the sale of receivables depends in part on the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests based on their relative fair value at the date of transfer.

The beneficial interest in the Master Trust is accounted for as an available-for-sale security and is recorded at fair value. The Company estimates fair value of its beneficial interest in the Master Trust, both upon initial securitization and thereafter, based on the present value of future expected cash flows using management's best estimates of key assumptions including credit losses and payment rates. As of February 25, 2006 and February 26, 2005, the Company's assumptions used to calculate the present value of the future cash flows included estimated credit losses of 4.75% and 5%, respectively, of the outstanding balance, expected payment within a six-month period and a discount rate representing the average market rate the Company would expect to pay if it sold securities representing ownership in the excess receivables not required to collateralize the Class A Certificates. A sensitivity analysis performed assuming a hypothetical 20% adverse change in both interest rates and credit losses resulted in an immaterial impact on the fair value of the Company's beneficial interest. Although not anticipated by the Company, a significant deterioration in the financial condition of the Company's credit card holders, interest rates, or other economic conditions could result in other than temporary losses on the beneficial interest in future periods. *See Note 4 of the Notes to Consolidated Financial Statements for further discussion.*

**Inventories** — Inventories are comprised of finished merchandise and are stated at the lower of average cost or market, cost being determined on a weighted average inventory method. Cost is calculated based upon the actual landed cost of an item at the time it is received in the Company's warehouse using actual vendor invoices, the cost of warehousing and transporting product to the stores and other direct costs associated with purchasing products.

The Company recognizes known inventory losses, shortages and damages when incurred and maintains a reserve for estimated shrinkage since the last physical count, when actual shrink was recorded. The reserves for estimated shrink at the end of fiscal years 2006 and 2005 were \$8,218,000 and \$4,711,000, respectively. The increase was a result of timing of physical counts and not of an increase in rates of shrink.

**Properties, maintenance and repairs** — Buildings, equipment, furniture and fixtures, and leasehold improvements are carried at cost less accumulated depreciation. Depreciation is computed using the straight-line method over estimated remaining useful lives of the assets, generally thirty years for buildings and three to ten years for equipment, furniture and fixtures. Depreciation of improvements to leased properties is based upon the shorter of the remaining primary lease term or the estimated useful lives of such assets. Depreciation related to the Company's distribution centers is included in cost of sales. All other depreciation costs are included in depreciation and amortization. Depreciation costs were \$54,870,000, \$54,404,000 and \$47,514,000 in fiscal 2006, 2005 and 2004, respectively.

Expenditures for maintenance, repairs and renewals that do not materially prolong the original useful lives of the assets are charged to expense as incurred. In the case of disposals, assets and the related depreciation are removed from the accounts and the net amount, less proceeds from disposal, is credited or charged to income.

Long-lived assets are reviewed at the store level for impairment at least annually and whenever an event or change in circumstances indicates that its carrying value may not be recoverable. If the carrying value exceeds the sum of the expected undiscounted cash flows, the asset is impaired. Expected cash flows are estimated based on management's estimate of changes in sales, merchandise margins, and expenses over the remaining expected terms of the leases. Impairment is measured as the amount by which the

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

carrying value of the asset exceeds the fair value of the asset. Fair value is determined by discounting expected cash flows. Impairment, if any, is recorded in the period in which the impairment occurred. Impairment charges were \$5,601,000, \$370,000 and \$459,000 in fiscal 2006, 2005 and 2004, respectively, and included in selling, general and administrative expenses.

**Goodwill and intangible assets** — The Company applies the provisions of SFAS No. 142, “Goodwill and Intangible Assets.” Under SFAS No. 142, goodwill and intangible assets with indefinite useful lives are not amortized, but instead are tested for impairment at least annually. In accordance with SFAS No. 142, the Company’s reporting units were identified as components, and the goodwill assigned to each represents the excess of the original purchase price over the fair value of the net identifiable assets acquired for that component. The Company completed the annual impairment tests as of February 25, 2006 and February 26, 2005 for fiscal 2006 and 2005, respectively. The impairment tests were conducted by performing analyses of discounted future cash flows for the applicable reporting units. The analysis resulted in a write-down of intangible assets of \$239,000, included in selling, general and administrative expenses, in fiscal 2006. No impairment loss was recognized in fiscal 2005 or fiscal 2004. *See Note 6 of the Notes to Consolidated Financial Statements for additional discussion of goodwill and intangible assets.*

**Revenue recognition** — Revenue is recognized upon customer receipt or delivery for retail sales, net of sales tax, including sales under deferred payment promotions on the Company’s proprietary credit card. A reserve has been established for estimated merchandise returns based upon historical experience and other known factors. The reserves for estimated merchandise returns at the end of fiscal years 2006 and 2005 were \$3,060,000 and \$3,330,000, respectively. The Company’s revenues are reported net of discounts and returns, and include wholesale sales and royalties received from franchise stores and Sears Roebuck de Mexico S.A. de C.V. Amounts billed to customers for shipping and handling are included in net sales and the costs incurred by the Company for these items are recorded in cost of sales.

**Gift cards** — Revenue associated with gift cards is recognized upon redemption of the gift card. Gift card breakage is estimated and recorded as income based upon an analysis of the Company’s historical redemption patterns and represents the remaining unused portion of the gift card liability for which the likelihood of redemption is remote.

**Leases** — The Company leases certain property consisting principally of retail stores, warehouses, and material handling and office equipment under leases expiring through fiscal 2021. Most retail store locations are leased for primary terms of 10 to 15 years with varying renewal options and rent escalation clauses. Escalations occurring during the primary terms of the leases are included in the calculation of the minimum lease payments, and the rent expense related to these leases is recognized on a straight-line basis over this lease term. Prior to fiscal 2005, the Company recognized straight-line rent expense for store leases beginning on the earlier of the rent commencement date or the store opening date, which had the effect of excluding the build-out period of its stores from the calculation of the period over which it expenses rent. During the fourth quarter of fiscal 2005, the Company revised its accounting practices to extend the lease term to include this free rent period prior to the opening of its stores. This revision in practice resulted in a cumulative pre-tax charge of \$6,264,000 for leases entered into prior to fiscal 2005, which was not material to any previously reported fiscal year. This cumulative adjustment had no effect on historical or future cash flows from operations or the timing of payments under the related leases. The portion of rent expense applicable to a store before opening is included in selling, general and administrative expenses. Once opened for business, rent expense is included in cost of sales. Certain leases provide for additional rental payments based on a percentage of sales in excess of a specified base. This additional rent is accrued when it appears that the sales will exceed the specified base. Construction allowances received from landlords are initially recorded as lease liabilities and amortized as a reduction of rental expense over the primary lease term. The Company’s lease obligations are considered operating leases under SFAS No. 13.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**Advertising costs** — Advertising production costs are expensed the first time the advertising takes place. Advertising costs were \$92,245,000, \$79,115,000 and \$79,908,000 in fiscal 2006, 2005 and 2004, respectively. Prepaid advertising at the end of fiscal years 2006 and 2005 was \$5,413,000 and \$2,853,000, respectively.

**Pension costs** — The Company maintains supplemental retirement plans (the “Plans”) for certain of its executive officers. The Plans provide that upon death, disability or reaching retirement age, a participant will receive benefits based on highest compensation and years of service. These benefit costs are dependent upon numerous factors, assumptions and estimates. Benefit costs may be significantly affected by changes in key actuarial assumptions such as the discount rate, compensation rates, or retirement dates used to determine the projected benefit obligation. Additionally, changes made to the provisions of the Plans may impact current and future benefit costs. In accordance with accounting rules, changes in benefit obligations associated with these factors may not be immediately recognized as costs on the income statement, but are recognized in future years over the remaining average service period of plan participants. *See Note 11 of the Notes to Consolidated Financial Statements for further discussion.*

**Income taxes** — The Company records income tax expense using the liability method for taxes. Under this method, deferred tax assets and liabilities are recognized based on differences between financial statement and tax bases of assets and liabilities using presently enacted tax rates. Deferred tax assets and liabilities are classified as current or noncurrent based on the classification of the related assets or liabilities for financial reporting purposes. A valuation allowance is recorded to reduce the carrying amounts of deferred tax assets unless it is more likely than not that such assets will be realized. Deferred federal income taxes, net of applicable foreign tax credits, are not provided on the undistributed earnings of foreign subsidiaries to the extent the Company intends to permanently reinvest such earnings abroad. At any point in time, multiple tax years are subject to audit by various jurisdictions and the Company records reserves for estimates of probable tax exposures of foreign and domestic tax audits. The results and timing of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues.

**Earnings per share** — Basic earnings (loss) per share amounts were determined by dividing income (loss) from continuing operations, income (loss) from discontinued operations and net income (loss) by the weighted average number of common shares outstanding for the period. Diluted earnings per share amounts were similarly computed, but included the effect, when dilutive, of the Company’s weighted average number of stock options outstanding and unvested restricted stock.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Earnings per share amounts were calculated as follows (in thousands except per share amounts):

	2006	2005	2004
Income (loss) from continuing operations, basic and diluted ..	\$(27,471)	\$62,765	\$117,704
Income (loss) from discontinued operations, basic and diluted	(12,333)	(2,308)	297
Net income (loss), basic and diluted .....	<u>\$(39,804)</u>	<u>\$60,457</u>	<u>\$118,001</u>
Average shares outstanding:			
Basic .....	86,629	87,037	89,294
Plus assumed exercise of stock options .....	—	1,801	2,330
Diluted .....	<u>86,629</u>	<u>88,838</u>	<u>91,624</u>
Earnings (loss) per share from continuing operations:			
Basic .....	<u>\$ (.32)</u>	<u>\$ .72</u>	<u>\$ 1.32</u>
Diluted .....	<u>\$ (.32)</u>	<u>\$ .71</u>	<u>\$ 1.29</u>
Earnings (loss) per share from discontinued operations:			
Basic .....	<u>\$ (.14)</u>	<u>\$ (.03)</u>	<u>\$ .00</u>
Diluted .....	<u>\$ (.14)</u>	<u>\$ (.03)</u>	<u>\$ .00</u>
Net earnings (loss) per share:			
Basic .....	<u>\$ (.46)</u>	<u>\$ .69</u>	<u>\$ 1.32</u>
Diluted .....	<u>\$ (.46)</u>	<u>\$ .68</u>	<u>\$ 1.29</u>

Stock options for which the exercise price was greater than the average market price of common shares were not included in the computation of diluted earnings per share as the effect would be antidilutive. All 12,941,025 outstanding shares of stock options and unvested restricted stock were excluded from the computation of the fiscal 2006 loss per share as the effect would be antidilutive. At the end of fiscal years 2005 and 2004, there were 5,210,600 and zero, respectively, stock options outstanding with exercise prices greater than the average market price of the Company's common shares. In addition, incremental net shares for the conversion feature of the Company's 6.375% senior convertible notes will be included in the Company's future diluted earnings per share calculations for those periods in which the average common stock price exceeds the initial conversion price of \$15.19 per share.

**Stock-based compensation** — The Company grants stock options and restricted stock for a fixed number of shares to employees with stock option exercise prices equal to the fair market value of the shares on the date of grant. The Company accounts for stock option grants and restricted stock grants under the intrinsic value method in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and, accordingly, recognizes no compensation expense for the stock option grants.

During the third quarter of fiscal 2006, the Company's Board of Directors approved the accelerated vesting of certain stock options where the exercise price was in excess of the market price. This acceleration resulted in pro forma expense of approximately \$16,300,000, net of tax, for options that would have vested in future periods. *See Note 12 of the Notes to Consolidated Financial Statements for additional discussion related to the accounting for stock-based employee compensation.*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table illustrates the effect on net income (loss) and earnings (loss) per share from continuing operations if the fair value-based method had been applied to all outstanding awards in each period (in thousands except per share amounts):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Income (loss) from continuing operations, as reported .....	\$(27,471)	\$ 62,765	\$117,704
Stock-based employee compensation expense included in reported net income (loss), net of related tax effects .....	417	—	—
Less total stock-based employee compensation expense determined under fair value-based method, net of related tax effects .....	<u>(25,519)</u>	<u>(11,645)</u>	<u>(8,899)</u>
Pro forma income (loss) from continuing operations .....	<u><u>\$(52,573)</u></u>	<u><u>\$ 51,120</u></u>	<u><u>\$108,805</u></u>
Earnings (loss) per share from continuing operations:			
Basic — as reported .....	<u><u>\$ (.32)</u></u>	<u><u>\$ .72</u></u>	<u><u>\$ 1.32</u></u>
Basic — pro forma .....	<u><u>\$ (.61)</u></u>	<u><u>\$ .59</u></u>	<u><u>\$ 1.22</u></u>
Diluted — as reported .....	<u><u>\$ (.32)</u></u>	<u><u>\$ .71</u></u>	<u><u>\$ 1.29</u></u>
Diluted — pro forma .....	<u><u>\$ (.61)</u></u>	<u><u>\$ .57</u></u>	<u><u>\$ 1.19</u></u>

**Adoption of new accounting standards** — In December 2004, the Financial Accounting Standards Board (the “FASB”) issued SFAS No. 123 (Revised 2004), “Share-Based Payment” (“SFAS 123R”). This statement replaces FASB Statement No. 123, “Accounting for Stock-Based Compensation,” and supercedes APB Opinion No. 25, “Accounting for Stock Issued to Employees.” SFAS 123R requires all companies to measure compensation cost for all share-based payments, including stock options, at fair value. The statement will be effective for public companies no later than the beginning of the first fiscal year commencing after June 15, 2005, which for the Company is the beginning of fiscal 2007. In March 2005, the Securities & Exchange Commission (the “SEC”) issued Staff Accounting Bulletin No. 107, “Share-Based Payment” (“SAB 107”). SAB 107 summarizes the views of the SEC staff regarding the interaction between SFAS 123R and certain SEC rules and regulations, and is intended to assist in the initial implementation of SFAS 123R. The Company will adopt SFAS 123R using the modified prospective method and is currently evaluating the effect that SFAS 123R and SAB 107 will have on its consolidated balance sheets and its statements of shareholders’ equity and cash flows. However, the Company estimates equity compensation costs to be in the range of \$2,500,000 to \$5,600,000 for fiscal 2007 depending on the timing and number of stock options and restricted shares granted during fiscal 2007. SFAS 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated, because they depend on, among other things, when employees exercise stock options. However, the amount of operating cash flows recognized for such excess tax deductions for the years ended February 25, 2006, February 26, 2005 and February 28, 2004 was not material.

In March 2005, the FASB issued FASB Interpretation No. 47, “Accounting for Conditional Asset Retirement Obligations” (“FIN 47”), which is an interpretation of SFAS No. 143, “Accounting for Asset Retirement Obligations.” FIN 47 clarifies terminology within SFAS No. 143 and requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability’s fair value can be reasonably estimated. FIN 47 is effective for fiscal years ending after December 15, 2005. The adoption of FIN 47 did not have a material impact on the Company’s consolidated balance sheets or statements of operations, shareholders’ equity and cash flows.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"). SFAS 154 replaces APB No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements" and establishes retrospective application as the required method for reporting a change in accounting principle. SFAS 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The reporting of a correction of an error by restating previously issued financial statements is also addressed. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. SFAS 154 will have no impact on the Company's consolidated balance sheets and statements of operations, shareholders' equity and cash flows unless at a future date the Company has an accounting change or correction of an error.

In June 2005, the FASB's Emerging Issues Task Force reached a consensus on Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements" ("EITF 05-6"). This guidance requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. This guidance was effective for interim reporting periods beginning after June 29, 2005, and is applicable only to leasehold improvements that are purchased or acquired in reporting periods beginning after the effective date. The adoption of EITF 05-6 did not have an impact on the Company's consolidated balance sheets and statements of operations, shareholders' equity and cash flows.

In October 2005, the FASB issued FASB Staff Position No. FAS 13-1, "Accounting for Rental Costs Incurred during a Construction Period" ("FSP 13-1"). The guidance requires rental costs for operating leases during the construction period to be recognized as rental expense. The guidance permits either retroactive or prospective treatment for periods beginning after December 15, 2005. The Company currently complies with this guidance and, therefore, the application of FSP 13-1 is not expected to have a material effect on the Company's consolidated balance sheets and statements of operations, shareholders' equity and cash flows.

### NOTE 2 — RESTATED STATEMENTS OF CASH FLOWS

In the fourth quarter of fiscal 2006, the Company reevaluated its classification within the consolidated statements of cash flows of cash received from its retained interest in the securitized proprietary credit card receivables. Based on this reevaluation, management determined that the classification related to the line item "Beneficial interest in securitized receivables" netted within the investing section of the consolidated statements of cash flows was not in compliance with U.S. generally accepted accounting principles. The Company had not appropriately reflected the exchange of its proprietary credit card receivables for its retained interest in the securitized receivables as a non-monetary transaction. As a result, both cash provided by operating activities and cash used in investing activities were overstated in the consolidated statements of cash flows in each of the two years ended February 26, 2005. Accordingly, the Company has restated the fiscal 2005 and fiscal 2004 statements of cash flows.

As a result of the restatement, operating cash flow decreased by \$91,071,000 and \$83,931,000 and investing cash flow increased by \$91,071,000 and \$83,931,000 for the years ended February 26, 2005 and

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

February 28, 2004, respectively. These restatements, which have no effect on total cash flows, are disclosed in the following tables (in thousands):

	<u>As Presented</u>	<u>Adjustment</u>	<u>As Restated</u>
For the fiscal year ended February 26, 2005:			
Net cash provided by operating activities .....	\$ 142,201	\$(91,071)	\$ 51,130
Net cash used in investing activities .....	(97,553)	91,071	(6,482)
Net cash used in financing activities .....	(80,668)	—	(80,668)
Change in cash and cash equivalents .....	(36,020)	—	(36,020)
Cash and cash equivalents at beginning of period (including cash held for sale of \$6,148) .....	225,101	—	225,101
Cash and cash equivalents at end of period (including cash held for sale of \$3,359) .....	<u>\$ 189,081</u>	<u>\$ —</u>	<u>\$ 189,081</u>
For the fiscal year ended February 28, 2004:			
Net cash provided by operating activities .....	\$ 177,676	\$(83,931)	\$ 93,745
Net cash used in investing activities .....	(100,635)	83,931	(16,704)
Net cash used in financing activities .....	(94,054)	—	(94,054)
Change in cash and cash equivalents .....	(17,013)	—	(17,013)
Cash and cash equivalents at beginning of period (including cash held for sale of \$6,506) .....	242,114	—	242,114
Cash and cash equivalents at end of period (including cash held for sale of \$6,148) .....	<u>\$ 225,101</u>	<u>\$ —</u>	<u>\$ 225,101</u>

### NOTE 3 — DISCONTINUED OPERATIONS

During the fourth quarter of fiscal 2006, the Company's Board of Directors authorized management to sell its operations of The Pier Retail Group Limited ("The Pier") with stores located in the United Kingdom and Ireland. The Company met the criteria of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" that allowed it to classify The Pier as held for sale and present its results of operations as discontinued for all years presented. In the fourth quarter of fiscal 2006, the Company recorded an impairment charge of \$7,441,000 to write down \$918,000 of goodwill and \$6,523,000

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

related to properties to the fair value less costs to sell. Assets held for sale and liabilities related to assets held for sale were comprised of the following components (in thousands):

	<u>2006</u>	<u>2005</u>	
Cash and cash equivalents .....	\$ 7,100	\$ 3,359	
Accounts receivable .....	1,441	654	
Inventory .....	10,870	14,963	
Prepaid expenses and other current assets .....	2,270	2,429	
Properties, net .....	10,678	17,492	
Goodwill .....	—	918	
Assets held for sale .....	<u>\$32,359</u>	<u>\$39,815</u>	
Accounts payable .....	\$ 5,728	\$ 5,370	
Deferred revenue .....	415	503	
Accrued income taxes payable .....	137	151	
Other accrued liabilities .....	7,210	6,570	
Other noncurrent liabilities .....	<u>3,351</u>	<u>2,569</u>	
Liabilities related to assets held for sale .....	<u>\$16,841</u>	<u>\$15,163</u>	
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net sales from discontinued operations .....	<u>\$74,196</u>	<u>\$72,510</u>	<u>\$62,151</u>

Also, included in assets held for sale are deferred tax assets of \$8,096,000 and \$5,619,000 at February 25, 2006 and February 26, 2005, respectively, both of which were fully reserved through a valuation allowance.

*See Note 15 of the Notes to Consolidated Financial Statements for discussion of the sale of The Pier subsequent to year end.*

### NOTE 4 — PROPRIETARY CREDIT CARD INFORMATION

The Company's proprietary credit card receivables were generated under open-ended revolving credit accounts issued by its subsidiary, Pier 1 National Bank, to finance purchases of merchandise and services offered by the Company. These accounts have various billing and payment structures, including varying minimum payment levels. The Company has an agreement with a third party to provide certain credit card processing and related credit services, while the Company maintains control over credit policy decisions and customer service standards.

As of fiscal 2006 year-end, the Company had approximately 5,900,000 proprietary cardholders and approximately 1,033,000 customer credit accounts considered active (accounts with a purchase within the previous 12 months). Net proprietary credit card income was included in selling, general and administrative expenses on the Company's statements of operations. The following information presents a

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

summary of the Company's proprietary credit card results for each of the last three fiscal years on a managed basis (in thousands):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Income:			
Finance charge income, net of debt service costs . . . . .	\$ 27,351	\$ 25,118	\$ 25,396
Other income . . . . .	<u>189</u>	<u>114</u>	<u>105</u>
	<u>27,540</u>	<u>25,232</u>	<u>25,501</u>
Costs:			
Processing fees . . . . .	13,907	14,982	14,540
Bad debts . . . . .	<u>6,457</u>	<u>7,026</u>	<u>8,200</u>
	<u>20,364</u>	<u>22,008</u>	<u>22,740</u>
Net proprietary credit card income . . . . .	<u>\$ 7,176</u>	<u>\$ 3,224</u>	<u>\$ 2,761</u>
Proprietary credit card sales . . . . .	<u>\$422,525</u>	<u>\$461,191</u>	<u>\$436,809</u>
Costs as a percent of proprietary credit card sales . . . . .	<u>4.82%</u>	<u>4.77%</u>	<u>5.21%</u>
Gross proprietary credit card receivables at year-end . . . . .	<u>\$147,271</u>	<u>\$134,326</u>	<u>\$142,228</u>
Proprietary credit card sales as a percent of total U.S. store sales . . . . .	<u>25.7%</u>	<u>27.1%</u>	<u>25.9%</u>

The Company began securitizing its entire portfolio of proprietary credit card receivables (the "Receivables") in fiscal 1997. On a daily basis during all periods presented above, the Company sold all of its proprietary credit card receivables, except an immaterial amount of those that failed certain eligibility criteria, to a special-purpose wholly owned subsidiary, Pier 1 Funding, LLC ("Funding"). The Receivables were then transferred from Funding to the Pier 1 Imports Credit Card Master Trust (the "Master Trust"). In exchange for the Receivables, the Company received cash and retained a residual interest in the Master Trust. These cash payments were funded from undistributed principal collections on the Receivables that were previously sold to the Master Trust.

Funding was capitalized by the Company as a special-purpose wholly owned subsidiary and is subject to certain covenants and restrictions, including a restriction from engaging in any business or activity unrelated to acquiring and selling interests in receivables. The Master Trust issues beneficial interests that represent undivided interests in the assets of the Master Trust. Neither Funding nor the Master Trust is consolidated in the Company's financial statements. Under U.S. generally accepted accounting principles, if the structure of a securitization meets certain requirements, such transactions are accounted for as sales of receivables. As the Company's securitizations met such requirements, they were accounted for as sales. Gains or losses resulting from the sales of Receivables were not material during fiscal 2006, 2005 or 2004. The Company's exposure to deterioration in the performance of the Receivables is limited to its retained beneficial interest in the Master Trust. As such, the Company has no corporate obligation to reimburse Funding, the Master Trust or purchasers of any certificates issued by the Master Trust for credit losses from the Receivables.

As a result of the securitization, the Master Trust has \$100,000,000 of outstanding 2001-1 Class A Certificates issued to a third party. The 2001-1 Class A Certificates bear interest at a floating rate equal to the rate on commercial paper issued by the third party plus a credit spread. As of February 25, 2006 and February 26, 2005, these rates were 5.1% and 3.0%, respectively. Funding continues to retain the residual interest in the Master Trust and held \$13,636,000 and \$9,290,000 in 2001-1 Class B Certificates at

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

February 25, 2006 and February 26, 2005, respectively, which are subordinated to the 2001-1 Class A Certificates and do not bear interest.

The 2001-1 Class A Certificates have a revolving period of 364 days, which can be extended by mutual consent of Funding and the third-party holder, and expire in August 2006. The Company does not provide recourse to the third-party investor that purchased these debt securities issued by the Master Trust. During fiscal 2006, the Company's securitization agreements were amended to, among other things, extend the expiration date until September 2006 and to increase the amount of Class B Certificates required to be held by Funding for the benefit and protection of Class A Certificate holders from \$9,290,000 to \$13,636,000 if the Company's credit ratings fall below certain required minimums. During fiscal 2006, the Company's credit rating fell below this minimum and in February 2006, the Class B Certificates were increased to \$13,636,000 raising the minimum amount of receivables necessary to avoid repayment of the Class A Certificates. Should the balance of the underlying Receivables held by the Master Trust decline to a level that the Class A Certificates were insufficiently collateralized, the Master Trust would be contractually required to repay a portion of the Class A Certificates from daily collections, thereby reducing funds available for purchases of newly generated Receivables. At the end of fiscal 2006, the underlying Receivables held by the Master Trust were \$147,271,000 and would have had to fall below \$122,190,000 before a repayment would have been required. This repayment would only be to the extent necessary to maintain the required ratio of receivables to the Class A Certificates as set forth in the securitization agreement. In addition, the failure of the Master Trust to comply with its required performance measures, such as payment rate, dilution rate, portfolio yield and minimum transferor's interest; the failure of the Company to meet the minimum credit rating requirement; or other material adverse changes in the Company's credit quality, would trigger an early amortization event. Such an event would require the Master Trust to repay the Class A Certificates, thereby reducing funds available for purchases of newly generated Receivables. These performance measures would have to deteriorate significantly to result in such an early amortization event.

Cash flows received by the Company from the Master Trust for each of the last three fiscal years are as follows (in thousands):

	2006	2005	2004
		(as restated, See Note 2)	(as restated, See Note 2)
Proceeds from collections reinvested in revolving securitizations .....	\$436,034	\$494,580	\$454,444
Servicing fees received .....	\$ 2,189	\$ 2,186	\$ 2,186
Cash flows received on retained interests .....	\$ 95,444	\$109,172	\$101,203

As of February 25, 2006 and February 26, 2005, the Company had \$50,000,000 and \$35,690,000, respectively, in beneficial interests (comprised primarily of principal and interest related to the underlying Receivables) in the Master Trust. Cash flows received on retained interests were restated from \$170,671,000 and \$145,325,000 in fiscal 2005 and 2004, respectively, as part of the restatement discussed in *Note 2 of the Notes to Consolidated Financial Statements*.

# **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

## **NOTE 5 — PROPERTIES**

Properties are summarized as follows at February 25, 2006 and February 26, 2005 (in thousands):

	<u>2006</u>	<u>2005</u>
Land .....	\$ 18,778	\$ 19,627
Buildings .....	95,056	98,184
Equipment, furniture and fixtures .....	271,702	297,034
Leasehold improvements .....	217,795	218,006
Computer software .....	60,208	63,515
Projects in progress .....	<u>5,673</u>	<u>6,394</u>
	669,212	702,760
Less accumulated depreciation and amortization .....	<u>370,290</u>	<u>382,622</u>
Properties, net	<u><u>\$298,922</u></u>	<u><u>\$320,138</u></u>

## **NOTE 6 — GOODWILL AND OTHER INTANGIBLE ASSETS**

The Company's intangible assets at February 25, 2006 and February 26, 2005 included the right to do business within certain geographical markets where franchise stores were previously granted exclusive rights to operate, favorable operating leases acquired from a third party and goodwill related primarily to the acquisition of Pier 1 Kids. These intangible assets were included in other noncurrent assets in the Company's consolidated balance sheets. Amortization expense for fiscal 2006, 2005 and 2004 was \$1,654,000, \$1,656,000 and \$1,493,000, respectively. The following is a summary of the Company's intangible assets at February 25, 2006 and February 26, 2005 (in thousands):

	<u>2006</u>	<u>2005</u>
Geographic market rights, gross .....	\$ 14,926	\$ 15,023
Accumulated amortization .....	<u>(13,088)</u>	<u>(11,639)</u>
Geographic market rights, net .....	<u>\$ 1,838</u>	<u>\$ 3,384</u>
Acquired operating leases, gross .....	\$ 1,615	\$ 1,975
Accumulated amortization .....	<u>(463)</u>	<u>(257)</u>
Acquired operating leases, net .....	<u>\$ 1,152</u>	<u>\$ 1,718</u>
Goodwill, not amortized .....	<u><u>\$ 4,088</u></u>	<u><u>\$ 4,088</u></u>

Estimated future amortization expense related to intangible assets at February 25, 2006 is as follows (in thousands):

<u>Fiscal Year</u>	<u>Amortization Expense</u>
2007 .....	\$1,530
2008 .....	617
2009 .....	155
2010 .....	153
2011 .....	129
Thereafter .....	<u>406</u>
Total future amortization expense .....	<u><u>\$2,990</u></u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### NOTE 7 — OTHER ACCRUED LIABILITIES AND NONCURRENT LIABILITIES

The following is a summary of other accrued liabilities and noncurrent liabilities at February 25, 2006 and February 26, 2005 (in thousands):

	<u>2006</u>	<u>2005</u>
Accrued payroll and other employee-related liabilities .....	\$ 39,448	\$ 37,034
Accrued taxes, other than income .....	24,652	22,929
Other .....	<u>33,393</u>	<u>35,760</u>
Other accrued liabilities .....	<u>\$ 97,493</u>	<u>\$ 95,723</u>
Rent-related liabilities .....	\$ 40,254	\$ 40,018
Retirement benefits .....	56,404	51,994
Other .....	<u>10,373</u>	<u>8,790</u>
Other noncurrent liabilities .....	<u>\$107,031</u>	<u>\$100,802</u>

### NOTE 8 — LEASE TERMINATION OBLIGATION

Although the Company typically does not terminate leases prior to their expiration, periodically certain stores or storage facilities with relatively short terms remaining on the leases are closed or relocated to more favorable locations within the same market. These decisions are based on lease renewal obligations, relocation space availability, general economic conditions and prospects for future profitability. In connection with these lease terminations, the Company recorded estimated liabilities in accordance with SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The estimated liabilities were recorded based upon the Company's remaining lease obligations less estimated subtenant rental income. Expenses related to lease termination obligations are included in selling, general and administrative expenses in the Company's consolidated statements of operations. The write-off of fixed assets and associated intangible assets related to store closures was approximately \$1,500,000 in fiscal 2006 and was not material in prior years. The write-down of inventory or employee severance costs associated with these closures was not significant in fiscal 2006; and, there were no write-downs for inventory or

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

employee severance costs in fiscal 2005 or 2004. The following table represents a rollforward of the liability balances for the three fiscal years ended February 25, 2006 (in thousands):

	Lease Termination Obligation
Balance at March 1, 2003 .....	\$ 782
Original charges .....	2,971
Revisions .....	287
Cash payments .....	<u>(2,292)</u>
Balance at February 28, 2004 .....	1,748
Original charges .....	1,480
Revisions .....	763
Cash payments .....	<u>(2,516)</u>
Balance at February 26, 2005 .....	1,475
Original charges .....	3,689
Revisions .....	487
Cash payments .....	<u>(2,792)</u>
Balance at February 25, 2006 .....	<u>\$ 2,859</u>

### NOTE 9 — LONG-TERM DEBT AND AVAILABLE CREDIT

Long-term debt is summarized as follows at February 25, 2006 and February 26, 2005 (in thousands):

	2006	2005
Industrial revenue bonds .....	\$ 19,000	\$19,000
6.375% convertible senior notes .....	<u>165,000</u>	<u>—</u>
	184,000	19,000
Less — portion due within one year .....	<u>—</u>	<u>—</u>
Long-term debt .....	<u>\$184,000</u>	<u>\$19,000</u>

In fiscal 1987, the Company entered into industrial revenue bond loan agreements aggregating \$25,000,000. Proceeds were used to construct three warehouse/distribution facilities. The loan agreements and related tax-exempt bonds mature in the year 2026. Subsequent to the sale of the old distribution center located in Savannah, Georgia, the Company repaid the related \$6,000,000 outstanding balance in industrial revenue bonds on December 1, 2003. The extinguishment of these bonds did not have a material impact on the Company's consolidated statement of operations. The Company's interest rates on the loans are based on the bond interest rates, which are market driven, reset weekly and are similar to other tax-exempt municipal debt issues. The Company's weighted average effective interest rates, including commitment fees of 1.0%, were 4.1% and 2.9% for fiscal 2006 and 2005, respectively.

In February 2006, the Company issued \$165,000,000 of 6.375% convertible senior notes due 2036 (the "Notes") in a private placement, and intends to register the Notes with the Securities and Exchange Commission by June 2006. The Notes bear interest at a rate of 6.375% per year until February 15, 2011 and at a rate of 6.125% per year thereafter. Interest is payable semiannually in arrears on February 15 and August 15 of each year, commencing August 15, 2006. The Notes are convertible into cash and, if applicable, shares of the Company's common stock based on an initial conversion rate, subject to adjustments, of 65.8328 shares per \$1,000 principal amount of Notes (which represents an initial conversion price of approximately \$15.19 per share representing a 40% conversion premium). Holders of



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

the Notes may convert their Notes only under the following circumstances: (1) during any fiscal quarter (and only during such fiscal quarter) commencing after May 27, 2006, if the last reported sale price of the Company's common stock is greater than or equal to 130% of the conversion price per share of common stock for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter; (2) if the Company has called the Notes for redemption; or (3) upon the occurrence of specified corporate transactions. In general, upon conversion of a Note, a holder will receive cash equal to the lesser of the principal amount of the Note or the conversion value of the Note and common stock of the Company for any conversion value in excess of the principal amount. As of February 25, 2006, the maximum number of shares that could be required to be issued to net share settle the conversion of the Notes is 10,862,412 shares. The Company may redeem the Notes at its option on or after February 15, 2011 for cash at 100% of the principal amount. Additionally, the holders of the Notes may require the Company to purchase all or a portion of their Notes under certain circumstances, in each case at a repurchase price in cash equal to 100% of the principal amount of the repurchased Notes at February 15, 2011, February 15, 2016, February 15, 2021, February 15, 2026 and February 15, 2031, or if certain fundamental changes occur. The Notes are fully and unconditionally guaranteed, on a joint and several basis, by all of the Company's material domestic consolidated subsidiaries.

In connection with the issuance of the Notes, the Company purchased a call option with respect to its common stock. If the call option, which expires February 15, 2011, is exercised by the Company, it must be net share settled and in all cases, the Company would receive shares. This transaction has no effect on the terms of the Notes, but is intended to reduce the potential dilution upon future conversion of the Notes by effectively increasing the initial conversion price to \$17.09 per share, representing a 57.5% conversion premium. The call option is exercisable under the same circumstances which can trigger conversion under the Notes. The cost of \$9,145,000 of the purchased call option was included in shareholders' equity, along with the partially offsetting tax benefit of the call option of \$3,396,000.

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19"), provides guidance for distinguishing between when a financial instrument should be accounted for permanently in equity, temporarily in equity or as an asset or liability. The conversion feature of the Notes and the call option each meet the requirements of EITF 00-19 to be accounted for as equity instruments. Therefore, the conversion feature has not been accounted for as a derivative, which would require a mark-to-market adjustment each period. In the event the debt is exchanged, the transaction will be accounted for with the cash payment of principal reducing the recorded liability and the issuance of common shares recorded in shareholders' equity. In addition, the premium paid for the call option has been recorded as additional paid-in capital in the accompanying consolidated balance sheet and is not accounted for as a derivative. Incremental net shares for the Note conversion feature will be included in the Company's future diluted earnings per share calculations for those periods in which the Company's average common stock price exceeds \$15.19 per share.

As a result of the offsetting call and put features of the Notes in five years, the Company anticipates the entire \$165,000,000 in Notes will be repaid on February 15, 2011. Therefore, the Notes are included in

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

fiscal 2011 long-term debt maturities in the table below. Long-term debt matures as follows (in thousands):

<u>Fiscal Year</u>	<u>Long-term Debt</u>
2007 .....	\$ —
2008 .....	—
2009 .....	—
2010 .....	—
2011 .....	165,000
Thereafter .....	<u>19,000</u>
Total long-term debt .....	<u>\$184,000</u>

In August 2003, the Company replaced its five-year \$125,000,000 revolving credit facility with a comparable three-year \$125,000,000 revolving credit facility, all of which was available at fiscal 2005 year-end. Proceeds of borrowings under the credit facility were available for working capital of the Company and for general corporate purposes. This agreement had a scheduled maturity date of August 2006 and had certain restrictive covenants which required, among other things, the maintenance of certain financial ratios including debt to net cash flow, fixed charge coverage and minimum tangible net worth. At the time this credit facility was repaid, it bore a floating interest rate (LIBOR plus 1.25%) based on the Company's corporate debt rating and required a commitment fee of 0.25% on unused amounts. The Company had no borrowings under either facility during fiscal 2005 and 2004.

In November 2005, the Company entered into a new \$325,000,000 secured credit facility which matures in November 2010. This facility is secured by the Company's eligible merchandise inventory and third-party credit card receivables. It replaced the Company's previous unsecured bank facilities, including the three-year \$125,000,000 revolving credit facility discussed above, the \$120,000,000 uncommitted letter of credit facility, and other credit lines used for special-purpose letters of credit. The new facility initially bears interest at LIBOR plus 1.0% for cash borrowings. The Company will not be required to comply with restrictive covenants under the new facility unless the facility has less than \$32,500,000 available under the borrowing base as defined in the agreement. As of February 25, 2006, the Company's borrowing base was \$221,547,000, of which \$127,082,000 was available for cash borrowings. The Company pays a fee of 1.0% for standby letters of credit, 0.5% for trade letters of credit and a commitment fee of 0.25% for any unused amounts. As of February 25, 2006, the Company had no outstanding cash borrowings and approximately \$94,465,000 in letters of credit utilized against the new secured credit facility. Of the outstanding balance, approximately \$43,635,000 related to trade letters of credit for merchandise purchases, \$29,000,000 related to standby letters of credit for the Company's workers' compensation and general liability insurance policies, \$19,430,000 related to standby letters of credit on the Company's industrial revenue bonds, and \$2,400,000 related to other miscellaneous standby letters of credit. This facility may limit certain investments and, in some instances, limit payment of dividends and repurchases of the Company's common stock. Under this new credit facility, the Company will not be restricted from paying dividends unless the availability under the facility is less than 30% of the Company's borrowing base calculation. The Company was in compliance with all material debt covenants at fiscal 2006 year-end. The Company was granted a waiver by the lenders subsequent to year-end in connection with the restatement of the Company's consolidated statements of cash flows for fiscal year 2005 and 2004.

### NOTE 10 — CONDENSED FINANCIAL STATEMENTS

The Company's 6.375% convertible senior notes are fully and unconditionally guaranteed, on a joint and several basis, by all of the Company's material domestic consolidated subsidiaries (the "Guarantor Subsidiaries"). The subsidiaries that do not guarantee such notes are comprised of the Company's foreign

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

subsidiaries and certain other insignificant domestic consolidated subsidiaries (the "Non-Guarantor Subsidiaries"). Each of the Guarantor Subsidiaries is wholly owned. The Company intends to register these Notes with the Securities and Exchange Commission by June 2006; therefore, in lieu of providing separate audited financial statements for the Guarantor Subsidiaries, condensed consolidating financial information is presented below.

## CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS

Year Ended February 25, 2006

(In thousands)

	Pier 1 Imports, Inc.	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Total
Net sales .....	\$ —	\$1,770,323	\$ 59,734	\$(53,356)	\$1,776,701
Cost of sales (including buying and store occupancy costs) .....	—	1,174,228	55,161	(54,378)	1,175,011
Selling, general and administrative (including depreciation and amortization) .....	1,163	641,833	1,506	—	644,502
Operating income (loss) .....	(1,163)	(45,738)	3,067	1,022	(42,812)
Nonoperating (income) expenses .....	711	(2,288)	677	—	(900)
Income (loss) from continuing operations before income taxes ....	(1,874)	(43,450)	2,390	1,022	(41,912)
Provision (benefit) for income taxes ...	—	(14,842)	401	—	(14,441)
Net income (loss) from continuing operations .....	(1,874)	(28,608)	1,989	1,022	(27,471)
Net income (loss) from subsidiaries ..	(38,952)	(10,344)	—	49,296	—
Discontinued operations:					
Loss from discontinued operations ...	—	—	(17,583)	—	(17,583)
Benefit for income taxes .....	—	—	(5,250)	—	(5,250)
Net loss from discontinued operations .....	—	—	(12,333)	—	(12,333)
Net income (loss) .....	<u>\$ (40,826)</u>	<u>\$ (38,952)</u>	<u>\$ (10,344)</u>	<u>\$ 50,318</u>	<u>\$ (39,804)</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS**

**Year Ended February 26, 2005**

**(In thousands)**

	<u>Pier 1 Imports, Inc.</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
Net sales .....	\$ —	\$1,820,003	\$61,934	\$(56,594)	\$1,825,343
Cost of sales (including buying and store occupancy costs) .....	—	1,124,380	53,808	(56,491)	1,121,697
Selling, general and administrative (including depreciation and amortization) .....	1,332	602,667	1,398	—	605,397
Operating income (loss) .....	(1,332)	92,956	6,728	(103)	98,249
Nonoperating (income) expenses .....	446	(1,828)	482	—	(900)
Income (loss) from continuing operations before income taxes .....	(1,778)	94,784	6,246	(103)	99,149
Provision for income taxes .....	—	35,313	1,071	—	36,384
Net income (loss) from continuing operations ....	(1,778)	59,471	5,175	(103)	62,765
Net income (loss) from subsidiaries .....	62,338	2,867	—	(65,205)	—
Discontinued operations:					
Loss from discontinued operations .....	—	—	(2,308)	—	(2,308)
Benefit for income taxes .....	—	—	—	—	—
Net loss from discontinued operations .....	—	—	(2,308)	—	(2,308)
Net income (loss) .....	<u>\$60,560</u>	<u>\$ 62,338</u>	<u>\$ 2,867</u>	<u>\$(65,308)</u>	<u>\$ 60,457</u>

**CONSOLIDATING CONDENSED STATEMENT OF OPERATIONS**

**Year Ended February 28, 2004**

**(In thousands)**

	<u>Pier 1 Imports, Inc.</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
Net sales .....	\$ —	\$1,802,056	\$60,122	\$(56,086)	\$1,806,092
Costs of sales (including buying and store occupancy costs) .....	—	1,049,065	51,976	(55,861)	1,045,180
Selling, general and administrative (including depreciation and amortization) .....	1,437	571,797	1,695	—	574,929
Operating income (loss) .....	(1,437)	181,194	6,451	(225)	185,983
Nonoperating (income) expenses .....	401	(2,514)	1,077	—	(1,036)
Income (loss) from continuing operations before income taxes .....	(1,838)	183,708	5,374	(225)	187,019
Provision for income taxes .....	—	68,259	1,056	—	69,315
Net income (loss) from continuing operations ...	(1,838)	115,449	4,318	(225)	117,704
Net income (loss) from subsidiaries .....	120,064	4,615	—	(124,679)	—
Discontinued operations:					
Income from discontinued operations .....	—	—	297	—	297
Provision for income taxes .....	—	—	—	—	—
Net income from discontinued operations .....	—	—	297	—	297
Net income (loss) .....	<u>\$118,226</u>	<u>\$ 120,064</u>	<u>\$ 4,615</u>	<u>\$(124,904)</u>	<u>\$ 118,001</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**CONSOLIDATING CONDENSED BALANCE SHEET**

**February 25, 2006**  
**(In thousands)**

	<u>Pier 1 Imports, Inc.</u>	<u>Guarantor Subsidiaries</u>	<u>Non-Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
<b>ASSETS</b>					
Current assets:					
Cash and cash equivalents .....	\$ 130,779	\$100,769	\$14,567	\$ —	\$ 246,115
Beneficial interest in securitized receivables .....	—	50,000	—	—	50,000
Other accounts receivable, net ....	279	12,444	1,193	—	13,916
Inventories .....	—	368,978	—	—	368,978
Income tax receivable .....	—	17,927	84	—	18,011
Assets held for sale .....	—	—	32,359	—	32,359
Prepaid expenses and other current assets .....	—	45,547	(3)	—	45,544
Total current assets .....	131,058	595,665	48,200	—	774,923
Properties, net .....	—	292,027	6,895	—	298,922
Investment in subsidiaries .....	475,698	25,074	—	(500,772)	—
Other noncurrent assets .....	9,588	86,349	79	—	96,016
	<u>\$ 616,344</u>	<u>\$999,115</u>	<u>\$55,174</u>	<u>\$(500,772)</u>	<u>\$1,169,861</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>					
Current liabilities:					
Accounts payable .....	\$ 201	\$103,700	\$ 2,015	\$ —	\$ 105,916
Intercompany payable (receivable) .....	(142,171)	125,165	17,006	—	—
Gift cards and other deferred revenue .....	—	63,835	—	—	63,835
Accrued income taxes payable (receivable) .....	—	10,563	(5,800)	—	4,763
Liabilities related to assets held for sale .....	—	—	16,841	—	16,841
Other accrued liabilities .....	885	96,570	38	—	97,493
Total current liabilities .....	(141,085)	399,833	30,100	—	288,848
Long-term debt .....	165,000	19,000	—	—	184,000
Other noncurrent liabilities .....	2,447	104,584	—	—	107,031
Shareholders' equity .....	589,982	475,698	25,074	(500,772)	589,982
	<u>\$ 616,344</u>	<u>\$999,115</u>	<u>\$55,174</u>	<u>\$(500,772)</u>	<u>\$1,169,861</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**CONSOLIDATING CONDENSED BALANCE SHEET**

**February 26, 2005**

**(In thousands)**

	<u>Pier 1 Imports, Inc.</u>	<u>Guarantor Subsidiaries</u>	<u>Non-Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Total</u>
<b>ASSETS</b>					
Current assets:					
Cash and cash equivalents . . . . .	\$ 482	\$ 157,542	\$27,698	\$ —	\$ 185,722
Beneficial interest in securitized receivables . . . . .	—	35,690	—	—	35,690
Other accounts receivable, net . . .	1	10,555	533	—	11,089
Inventories . . . . .	—	365,767	—	—	365,767
Assets held for sale . . . . .	—	—	39,815	—	39,815
Prepaid expenses and other current assets . . . . .	—	40,856	8	—	40,864
Total current assets . . . . .	483	610,410	68,054	—	678,947
Properties, net . . . . .	—	312,123	8,015	—	320,138
Investment in subsidiaries . . . . .	512,836	43,055	—	(555,891)	—
Other noncurrent assets . . . . .	932	75,653	79	—	76,664
	<u>\$ 514,251</u>	<u>\$1,041,241</u>	<u>\$76,148</u>	<u>\$ (555,891)</u>	<u>\$1,075,749</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>					
Current liabilities:					
Accounts payable . . . . .	\$ 3	\$ 105,767	\$ 2,362	\$ —	\$ 108,132
Intercompany payable (receivable) . . . . .	(152,453)	137,016	15,437	—	—
Gift cards and other deferred revenue . . . . .	—	60,844	—	—	60,844
Accrued income taxes payable . . .	—	11,626	90	—	11,716
Liabilities related to assets held for sale . . . . .	—	—	15,163	—	15,163
Other accrued liabilities . . . . .	351	95,331	41	—	95,723
Total current liabilities . . . . .	(152,099)	410,584	33,093	—	291,578
Long-term debt . . . . .	—	19,000	—	—	19,000
Other noncurrent liabilities . . . . .	1,981	98,821	—	—	100,802
Shareholders' equity . . . . .	664,369	512,836	43,055	(555,891)	664,369
	<u>\$ 514,251</u>	<u>\$1,041,241</u>	<u>\$76,148</u>	<u>\$ (555,891)</u>	<u>\$1,075,749</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**CONSOLIDATING CONDENSED STATEMENT OF CASH FLOW**

**Year Ended February 25, 2006**

**(In thousands)**

	<u>Pier 1 Imports, Inc.</u>	<u>Guarantor Subsidiaries</u>	<u>Non-Guarantor Subsidiaries<sup>(1)</sup></u>	<u>Eliminations</u>	<u>Total<sup>(1)</sup></u>
<b>Cash flow from operating activities:</b>					
Net cash provided by (used in) operating activities .....	\$ 3,029	\$(60,152)	\$ 16,443	\$(23,617)	\$(64,297)
<b>Cash flow from investing activities:</b>					
Capital expenditures .....	—	(46,229)	(4,750)	—	(50,979)
Proceeds from disposition of properties .....	—	1,401	—	—	1,401
Proceeds from the sale of restricted investments .....	—	3,226	—	—	3,226
Purchase of restricted investments ..	—	(3,500)	—	—	(3,500)
Collections of principal on beneficial interest in securitized receivables ...	—	60,240	—	—	60,240
Investment in subsidiaries .....	—	(9,889)	—	9,889	—
Net cash provided by (used in) investing activities .....	—	5,249	(4,750)	9,889	10,388
<b>Cash flow from financing activities:</b>					
Cash dividends .....	(34,667)	(50)	(23,567)	23,617	(34,667)
Purchases of treasury stock .....	(4,047)	—	—	—	(4,047)
Proceeds from stock options exercised, stock purchase plan and other, net .....	7,641	—	—	—	7,641
Issuance of long-term debt .....	165,000	—	—	—	165,000
Notes payable borrowings .....	—	86,500	—	—	86,500
Repayments of notes payable .....	—	(86,500)	—	—	(86,500)
Debt issuance costs .....	(5,369)	(1,370)	—	—	(6,739)
Purchase of call option .....	(9,145)	—	—	—	(9,145)
Contributions from parent .....	—	—	9,889	(9,889)	—
Advances from (to) subsidiaries ...	7,855	(450)	(7,405)	—	—
Net cash provided by (used in) financing activities .....	127,268	(1,870)	(21,083)	13,728	118,043
Change in cash and cash equivalents ...	130,297	(56,773)	(9,390)	—	64,134
Cash and cash equivalents at beginning of period .....	482	157,542	31,057	—	189,081
Cash and cash equivalents at end of period .....	<u>\$130,779</u>	<u>\$100,769</u>	<u>\$ 21,667</u>	<u>\$ —</u>	<u>\$253,215</u>

<sup>(1)</sup> Includes cash held for sale of \$3,359 at beginning of period and \$7,100 at end of period.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**CONSOLIDATING CONDENSED STATEMENT OF CASH FLOW**

**Year Ended February 26, 2005**

**(In thousands)**

	<u>Pier 1 Imports, Inc.</u>	<u>Guarantor Subsidiaries</u>	<u>Non-Guarantor Subsidiaries<sup>(1)</sup></u>	<u>Eliminations</u>	<u>Total<sup>(1)</sup></u>
<b>Cash flow from operating activities:</b>					
Net cash provided by operating activities .....	\$ 2,660	\$ 43,761	\$ 4,709	\$ —	\$ 51,130
<b>Cash flow from investing activities:</b>					
Capital expenditures .....	—	(95,491)	(3,748)	—	(99,239)
Proceeds from disposition of properties .....	—	3,852	—	—	3,852
Purchase of restricted investments ..	—	(10,807)	—	—	(10,807)
Collections of principal on beneficial interest in securitized receivables ...	—	99,712	—	—	99,712
Net cash used in investing activities ..	—	(2,734)	(3,748)	—	(6,482)
<b>Cash flow from financing activities:</b>					
Cash dividends .....	(34,762)	—	—	—	(34,762)
Purchases of treasury stock .....	(58,210)	—	—	—	(58,210)
Proceeds from stock options exercised, stock purchase plan and other, net .....	12,473	—	—	—	12,473
Debt issuance costs .....	(40)	(129)	—	—	(169)
Advances from (to) subsidiaries ...	74,116	(70,589)	(3,527)	—	—
Net cash used in financing activities ..	(6,423)	(70,718)	(3,527)	—	(80,668)
Change in cash and cash equivalents ...	(3,763)	(29,691)	(2,566)	—	(36,020)
Cash and cash equivalents at beginning of period .....	4,245	187,233	33,623	—	225,101
Cash and cash equivalents at end of period .....	<u>\$ 482</u>	<u>\$157,542</u>	<u>\$31,057</u>	<u>\$ —</u>	<u>\$189,081</u>

<sup>(1)</sup> Includes cash held for sale of \$6,148 at beginning of period and \$3,359 at end of period.



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**CONSOLIDATING CONDENSED STATEMENT OF CASH FLOW**

**Year Ended February 28, 2004**  
**(In thousands)**

	<u>Pier 1 Imports, Inc.</u>	<u>Guarantor Subsidiaries</u>	<u>Non-Guarantor Subsidiaries<sup>(1)</sup></u>	<u>Eliminations</u>	<u>Total<sup>(1)</sup></u>
<b>Cash flow from operating activities:</b>					
Net cash provided by (used in) operating activities .....	\$ 57,028	\$ 59,072	\$32,655	\$(55,010)	\$ 93,745
<b>Cash flow from investing activities:</b>					
Capital expenditures .....	—	(118,590)	(2,600)	—	(121,190)
Proceeds from disposition of properties .....	—	34,450	—	—	34,450
Purchase of restricted investments ...	—	(8,752)	—	—	(8,752)
Collections of principal on beneficial interest in securitized receivables ...	—	78,788	—	—	78,788
Investment in subsidiaries .....	<u>—</u>	<u>(83)</u>	<u>—</u>	<u>83</u>	<u>—</u>
Net cash provided by (used in) investing activities .....	—	(14,187)	(2,600)	83	(16,704)
<b>Cash flow from financing activities:</b>					
Cash dividends .....	(26,780)	(55,010)	—	55,010	(26,780)
Purchases of treasury stock .....	(76,009)	—	—	—	(76,009)
Proceeds from stock options exercised, stock purchase plan and other, net .....	15,709	—	—	—	15,709
Repayments of notes payable .....	—	(6,000)	(390)	—	(6,390)
Debt issuance costs .....	(411)	(173)	—	—	(584)
Contributions from parent .....	—	—	83	(83)	—
Advances from (to) subsidiaries .....	<u>34,578</u>	<u>(29,385)</u>	<u>(5,193)</u>	<u>—</u>	<u>—</u>
Net cash provided by (used in) financing activities .....	(52,913)	(90,568)	(5,500)	54,927	(94,054)
Change in cash and cash equivalents ...	4,115	(45,683)	24,555	—	(17,013)
Cash and cash equivalents at beginning of period .....	<u>130</u>	<u>232,916</u>	<u>9,068</u>	<u>—</u>	<u>242,114</u>
Cash and cash equivalents at end of period .....	<u>\$ 4,245</u>	<u>\$ 187,233</u>	<u>\$33,623</u>	<u>\$ —</u>	<u>\$ 225,101</u>

<sup>(1)</sup> Includes cash held for sale of \$6,506 at beginning of period and \$6,148 at end of period.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### NOTE 11 — EMPLOYEE BENEFIT PLANS

The Company offers a qualified, defined contribution employee retirement plan to all its full- and part-time personnel who are at least 18 years old and have been employed for a minimum of six months. Employees contributing 1% to 5% of their compensation receive a matching Company contribution of up to 3%. Company contributions to the plan were \$2,815,000, \$2,729,000 and \$2,349,000 in fiscal 2006, 2005, and 2004, respectively.

In addition, the Company offers non-qualified retirement savings plans for the purpose of providing deferred compensation for certain employees whose benefits under the qualified plan may be limited under Section 401(k) of the Internal Revenue Code. The Company's expense for these non-qualified plans was \$1,594,000, \$1,498,000 and \$1,356,000 for fiscal 2006, 2005 and 2004, respectively.

The Company maintains supplemental retirement plans (the "Plans") for certain of its executive officers. The Plans provide that upon death, disability or reaching retirement age, a participant will receive benefits based on highest compensation and years of service. The Company recorded expenses related to the Plans of \$8,934,000, \$4,378,000 and \$3,306,000 in fiscal 2006, 2005 and 2004, respectively.

The Plans are not funded and thus have no plan assets. However, a trust has been established for the purpose of setting aside funds to be used to settle the pension obligations upon retirement or death of certain participants. The trust assets are consolidated in the Company's financial statements and consist of interest yielding investments in the amounts of \$22,379,000 and \$21,386,000 at February 25, 2006 and February 26, 2005, respectively, and earned average rates of return of 3.4%, 1.4% and 0.9% in fiscal 2006, 2005 and 2004, respectively. These investments are restricted and may be used only to satisfy retirement obligations to certain participants and are classified in the financial statements as noncurrent assets. The Company has accounted for these restricted investments as available-for-sale securities. A cash contribution of \$3,500,000 was made to the trust in fiscal 2006. Any future contributions will be made at the discretion of the Compensation Committee of the Board of Directors and may be made in the form of cash or other assets such as life insurance policies. The Company owns and is the beneficiary of a number of insurance policies on the lives of current and past key executives. At February 25, 2006, the cash surrender value of these policies was \$19,656,000 and the death benefit was \$37,968,000. Restricted investments from the trust were sold to fund retirement benefits of \$3,226,000 in fiscal 2006. Funds from the trust will also be used to fund benefit payments through fiscal year 2016 that are expected to total approximately \$35,934,000. Of this amount, the Company expects to pay \$650,000 during fiscal 2007, \$29,225,000 during fiscal 2008, \$223,000 during fiscal 2009, \$238,000 during fiscal 2010, \$1,024,000 during fiscal 2011 and \$4,574,000 during fiscal years 2012 through 2016.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Measurement of obligations for the Plans is calculated as of each fiscal year-end. The following provides a reconciliation of benefit obligations and funded status of the Plans as of February 25, 2006 and February 26, 2005 (in thousands):

	<u>2006</u>	<u>2005</u>
Change in projected benefit obligation:		
Projected benefit obligation, beginning of year .....	\$ 36,342	\$ 23,073
Service cost .....	2,043	1,932
Interest cost .....	1,590	1,442
Actuarial loss .....	1,179	9,895
Settlement charge .....	1,008	—
Benefits paid .....	<u>(3,226)</u>	<u>—</u>
Projected benefit obligation, end of year .....	<u>\$ 38,936</u>	<u>\$ 36,342</u>
Reconciliation of funded status:		
Funded status .....	\$(38,936)	\$(36,342)
Unrecognized net loss .....	11,806	13,997
Unrecognized prior service cost .....	<u>3,609</u>	<u>4,532</u>
Accrued pension cost .....	(23,521)	(17,813)
Additional minimum liability .....	<u>(12,473)</u>	<u>(15,222)</u>
Accrued benefit liability/accumulated benefit obligation .....	<u>\$(35,994)</u>	<u>\$(33,035)</u>
Amounts recognized in the balance sheets:		
Accrued benefit liability .....	\$(35,994)	\$(33,035)
Intangible asset .....	3,609	4,531
Accumulated other comprehensive loss, pre-tax .....	<u>8,864</u>	<u>10,691</u>
Net amount recognized .....	<u>\$(23,521)</u>	<u>\$(17,813)</u>
(Decrease) increase in minimum liability included in comprehensive income, net of tax .....	<u>\$ (1,149)</u>	<u>\$ 4,780</u>
Minimum liability included in cumulative comprehensive income, net of taxes of \$3,291 and \$3,970, respectively .....	<u>\$ 5,573</u>	<u>\$ 6,721</u>
Weighted average assumptions used to determine:		
	<u>2006</u>	<u>2005</u>
Benefit obligation, end of year:		
Discount rate .....	5.00%	4.50%
Lump-sum conversion discount rate .....	2.75%	3.00%
Rate of compensation increase .....	3.50%	5.00%
Net periodic benefit cost for years ended:		
Discount rate .....	4.50%	6.25%
Lump-sum conversion discount rate .....	3.00%	3.25%
Rate of compensation increase .....	5.00%	5.00%

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Net periodic benefit cost included the following actuarially determined components during fiscal 2006, 2005 and 2004 (in thousands):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Service cost .....	\$2,043	\$1,932	\$ 701
Interest cost .....	1,590	1,442	1,414
Amortization of unrecognized prior service cost .....	830	830	862
Amortization of net actuarial loss .....	3,463	174	329
Other — settlement charge .....	<u>1,008</u>	<u>—</u>	<u>—</u>
Net periodic benefit cost .....	<u>\$8,934</u>	<u>\$4,378</u>	<u>\$3,306</u>

### NOTE 12 — MATTERS CONCERNING SHAREHOLDERS' EQUITY

**Stock purchase plan** — Substantially all employees are eligible to participate in the Pier 1 Imports, Inc. Stock Purchase Plan under which the Company's common stock is purchased on behalf of employees at market prices through regular payroll deductions. Each participant may contribute up to 10% of the eligible portions of compensation. The Company contributes from 10% to 100% of the participants' contributions, depending upon length of participation and date of entry into the plan. Company contributions to the plan were \$1,267,000, \$1,266,000 and \$1,174,000 in fiscal years 2006, 2005 and 2004, respectively.

**Restricted stock grant plan** — In fiscal 2006, the Company granted 218,000 shares of restricted stock awards to executive officers pursuant to the Pier 1 Imports, Inc. Management Restricted Stock Plan of which 203,000 remain outstanding. The fiscal 2006 stock grant will vest over a three year period of continued employment. The fair value at the date of grant of these restricted stock shares will be expensed over the aforementioned vesting period. Compensation expense for the restricted stock grant plan was \$636,000 in fiscal 2006. There was no compensation expense related to this plan for fiscal 2005 or 2004. As of fiscal 2006 year-end, 65,592 shares were available for future grants.

**Stock plans** — In June 1999, the Company adopted the Pier 1 Imports, Inc. 1999 Stock Plan (the "Plan"). The Plan will replace the Company's two previous stock option plans, which were the 1989 Employee Stock Option Plan (the "Employee Plan") and the 1989 Non-Employee Director Stock Option Plan (the "Director Plan").

The Plan provides for the granting of options to directors and employees with an exercise price not less than the fair market value of the common stock on the date of the grant. Options may be either Incentive Stock Options authorized under Section 422 of the Internal Revenue Code or nonqualified options, which do not qualify as Incentive Stock Options. Current director compensation provides for nonqualified options covering 6,000 shares to be granted once each year to each non-employee director. Additionally, the Plan authorizes a Director Deferred Stock Program. As the program is currently implemented by the Board of Directors, each director must defer a minimum of 50% and may defer up to 100% of the director's cash fees into a deferred stock account. The amount deferred receives a 50% matching contribution from the Company. The Plan provides that a maximum of 14,500,000 shares of common stock may be issued under the Plan, of which not more than 250,000 shares may be issued under the Directors Deferred Stock Program. Options issued to employees vest equally over a period of four years while non-employee directors' options are fully vested at the date of issuance. Both have a contractual life of ten years. Employee options will fully vest upon retirement or, under certain conditions, such as a change in control of the Company. The Company will continue to accelerate the vesting of employee options at the time of retirement until the adoption of SFAS 123R. Subsequent to adoption, options will be vested over the period of time from grant date to retirement eligibility. As of February 25, 2006 and February 26, 2005, respectively, there were 490,202 and 1,451,504 shares available for grant

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

under the Plan, of which 68,497 and 106,049 may be used for deferred stock issuance. Additionally, outstanding options covering 9,689,650 and 4,321,225 shares were exercisable under the Plan and 175,327 and 137,774 shares were issuable under the Directors Deferred Stock Program at fiscal years ended 2006 and 2005, respectively. The Plan will expire in June 2009, and the Board of Directors may at any time suspend or terminate the Plan or amend the Plan, subject to certain limitations.

Under the Employee Plan, options may be granted to qualify as Incentive Stock Options under Section 422 of the Internal Revenue Code or as nonqualified options. Most options issued under the Employee Plan vest over a period of four to five years and have a contractual life of ten years. As of February 25, 2006 and February 26, 2005, outstanding options covering 1,728,125 and 1,398,225 shares were exercisable, respectively. As a result of the expiration of the Employee Plan during fiscal 2005, no shares are available for future grant. The Director Plan expired in fiscal 2000. As of February 25, 2006 and February 26, 2005, outstanding options covering 20,250 and 27,000 shares, respectively, were exercisable under the Director Plan. As a result of the expiration of the Director Plan during fiscal 2000, no shares are available for future grants. Both plans were subject to adjustments for stock dividends and certain other changes to the Company's capitalization.

During fiscal 2006, the Company's Board of Directors approved the accelerated vesting of approximately 3,806,375 unvested stock options awarded to employees under the Company's stock option plans that had exercise prices exceeding the closing market price of \$11.20 at September 27, 2005, by more than 50% and were granted more than one year earlier. These options were granted between September 26, 2002, and June 28, 2004, and had exercise prices ranging from \$17.25 to \$20.38 per share. Of the 3,806,375 options that became exercisable immediately as a result of the vesting acceleration, 1,859,000 were scheduled to vest over the next 12 months. Because these stock options had exercise prices significantly in excess of the Company's current stock price, the Company believed that the future charge to earnings that would be required under SFAS 123R for the remaining original fair value of the stock options was not an accurate reflection of the economic value to the employees holding the options and that the options were not fully achieving their original objectives of employee retention and satisfaction. The Company also believed that the reduction in the Company's stock option compensation expense for fiscal years 2007 and 2008 would enhance comparability of the Company's financial statements with those of prior and subsequent years, since stock options are expected to represent a smaller portion of total compensation for the foreseeable future. SFAS 123R is effective for the Company at the beginning of its fiscal year 2007.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

A summary of stock option transactions related to the stock option plans during the three fiscal years ended February 25, 2006 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Fair Value at Date of Grant	Exercisable Shares Number of Shares	Weighted Average Exercise Price
Outstanding at March 1, 2003 .....	9,246,037	\$12.27		3,472,387	\$ 8.96
Options granted .....	2,984,000	19.41	\$8.67		
Options exercised .....	(1,033,370)	9.73			
Options cancelled or expired .....	(235,550)	16.32			
Outstanding at February 28, 2004 .....	10,961,117	14.37		4,568,117	10.46
Options granted .....	3,030,000	17.25	6.16		
Options exercised .....	(994,517)	7.86			
Options cancelled or expired .....	(723,275)	17.84			
Outstanding at February 26, 2005 .....	12,273,325	15.40		5,746,450	12.76
Options granted .....	1,477,000	14.26	4.75		
Options exercised .....	(397,100)	7.92			
Options cancelled or expired .....	(615,200)	17.36			
Outstanding at February 25, 2006 .....	<u>12,738,025</u>	15.41		11,438,025	15.54

For shares outstanding at February 25, 2006:

Ranges of Exercise Prices	Total Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Shares Currently Exercisable	Weighted Average Exercise Price - Exercisable Shares
\$5.81 — \$14.25 .....	5,136,625	\$10.21	5.39	3,846,625	\$ 8.87
\$15.42 — \$19.40 .....	5,321,400	18.29	7.82	5,311,400	18.29
\$20.35 — \$21.00 .....	2,280,000	20.39	6.59	2,280,000	20.39

The Company accounts for its stock options using the intrinsic value-based method of accounting prescribed by APB Opinion No. 25, but is required to disclose the pro forma effect on net income and earnings per share as if the options were accounted for using a fair value-based method of accounting. For purposes of computing pro forma net income and earnings per share, the fair value of the stock options is amortized on a straight-line basis as compensation expense over the vesting periods of the options. The fair values for options issued in fiscal 2006, 2005 and 2004 have been estimated as of the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2006	2005	2004
Weighted average fair value of options granted .....	\$ 4.75	\$ 6.16	\$ 8.67
Risk-free interest rates .....	3.84%	3.95%	3.00%
Expected stock price volatility .....	40.00%	40.00%	55.03%
Expected dividend yields .....	2.2%	1.5%	1.5%
Weighted average expected lives .....	5 years	5 years	5 years

Option valuation models are used in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility and the average life of options.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**Share purchase rights plan** — On December 9, 1994, the Board of Directors adopted a Share Purchase Rights Plan and declared a dividend of one common stock purchase right (a "Right") payable on each outstanding share of the Company's common stock on December 21, 1994, and authorized the issuance of Rights for subsequently issued shares of common stock. The Rights expired on December 21, 2004. Prior to its expiration, the Company's Board of Directors decided not to renew or extend the Share Purchase Rights Plan.

**Shares reserved for future issuances** — As of February 25, 2006, the Company had approximately 13,469,000 shares reserved for future issuances under the stock plans.

### NOTE 13 — INCOME TAXES

The provision (benefit) for income taxes for each of the last three fiscal years consists of (in thousands):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Federal:			
Current .....	\$ (2,402)	\$24,615	\$60,995
Deferred .....	(13,972)	2,414	152
State:			
Current .....	1,880	3,958	6,871
Deferred .....	(510)	(383)	9
Foreign:			
Current .....	577	5,776	1,265
Deferred .....	(14)	4	23
Provision (benefit) for income taxes from continuing operations ..	(14,441)	36,384	69,315
Provision (benefit) for income taxes from discontinued operations .....	(5,250)	—	—
Total provision (benefit) for income taxes .....	<u><u>\$ (19,691)</u></u>	<u><u>\$36,384</u></u>	<u><u>\$69,315</u></u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Deferred tax assets and liabilities from continuing operations at February 25, 2006 and February 26, 2005 were comprised of the following (in thousands):

	<u>2006</u>	<u>2005</u>
Deferred tax assets:		
Deferred compensation .....	\$ 21,033	\$ 17,760
Accrued average rent .....	14,785	13,351
Self insurance reserves .....	7,177	6,679
Minimum pension liability adjustment .....	3,291	3,970
Cumulative translation adjustment .....	1,234	703
Deferred revenue and revenue reserves .....	2,871	2,932
Purchased call option .....	3,377	—
Other .....	<u>3,609</u>	<u>2,760</u>
Total deferred tax assets .....	<u>57,377</u>	<u>48,155</u>
Deferred tax liabilities:		
Fixed assets, net .....	(7,693)	(13,038)
Inventory .....	(21,429)	(24,440)
Other .....	<u>(3,541)</u>	<u>(3,545)</u>
Total deferred tax liabilities .....	<u>(32,663)</u>	<u>(41,023)</u>
Net deferred tax assets .....	<u>\$ 24,714</u>	<u>\$ 7,132</u>

The Company has settled and closed all Internal Revenue Service (“IRS”) examinations of the Company’s tax returns for all years through fiscal 1999. The IRS is currently auditing fiscal years 2000, 2001 and 2002.

The difference between income taxes at the statutory federal income tax rate of 35% in fiscal 2006, 2005 and 2004, and income tax reported in continuing operations in the consolidated statements of operations is as follows (in thousands):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Tax at statutory federal income tax rate .....	\$(14,669)	\$34,702	\$65,457
State income taxes, net of federal benefit .....	880	2,172	3,849
Net foreign income taxed at lower rates, net of foreign tax credits .....	(687)	(1,206)	(703)
Other, net .....	<u>35</u>	<u>716</u>	<u>712</u>
Provision (benefit) for income taxes from continuing operations ..	<u>\$(14,441)</u>	<u>\$36,384</u>	<u>\$69,315</u>

The American Jobs Creation Act of 2004 (the “Jobs Act”), enacted on October 22, 2004, provided for a temporary 85% dividends received deduction on certain foreign subsidiary earnings repatriated during a one-year period. The deduction resulted in an approximate 5.25% federal tax rate on the repatriated earnings. There were numerous requirements that had to be satisfied for the repatriated earnings to qualify for the reduced rate of taxation. In September 2005, the Company finalized its evaluation of and the Company’s Board of Directors approved the repatriation of \$25,000,000 of foreign earnings under the provisions of the Jobs Act. The Company repatriated these earnings on September 30, 2005 and believes it has satisfied the requirements to qualify for the reduced rate of taxation. This repatriation of earnings had an insignificant effect on the Company’s effective tax rate during the twelve months ended February 25, 2006.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### NOTE 14 — COMMITMENTS AND CONTINGENCIES

**Leases** — At February 25, 2006, the Company had the following minimum lease commitments and future subtenant receipts from continuing operations in the years indicated (in thousands):

<u>Fiscal Year</u>	<u>Operating Leases</u>	<u>Subtenant Income</u>
2007 .....	\$ 235,947	\$305
2008 .....	221,853	179
2009 .....	202,287	94
2010 .....	183,051	19
2011 .....	160,381	6
Thereafter .....	<u>411,838</u>	<u>12</u>
Total lease commitments .....	<u>\$1,415,357</u>	<u>\$615</u>

Rental expense incurred was \$249,294,000, \$238,875,000 and \$209,217,000, including contingent rentals of \$260,000, \$391,000 and \$801,000, based upon a percentage of sales, and net of sublease incomes totaling \$311,000, \$262,000 and \$348,000 in fiscal 2006, 2005 and 2004, respectively.

During fiscal 2004, the Company completed a sale-leaseback transaction related to its distribution facility located in Savannah, Georgia. The resulting 15-year lease qualified for operating lease treatment. The Company received \$23,470,000 in proceeds in fiscal 2004, which approximated the net book value of the facility at the time of the sale.

**Legal matters** — There are various claims, lawsuits, investigations and pending actions against the Company and its subsidiaries incident to the operations of its business. The Company considers them to be ordinary and routine in nature. The Company maintains liability insurance against most of these claims. While certain of the lawsuits involve substantial amounts, it is the opinion of management, after consultation with counsel, that the ultimate resolution of such litigation will not have a material adverse effect on the Company's financial position, results of operations or liquidity. During fiscal 2004, the Company recorded a pre-tax charge of \$2,619,000 in a settlement of and legal fees related to a class action lawsuit in California regarding compensation matters. Cash outlays related to the settlement were completed in fiscal 2005.

### NOTE 15 — SUBSEQUENT EVENTS

On March 20, 2006, the Company sold its subsidiary based in the United Kingdom, The Pier Retail Group Limited, to Palli Limited for approximately \$15,000,000. Palli Limited is a wholly owned subsidiary of Lagerinn ehf, an Iceland corporation owned by Jakup a Dul Jacobsen. Collectively Lagerinn and Mr. Jacobsen beneficially owned approximately 9.9% of the Company's common stock on March 20, 2006.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

## NOTE 16 — SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

In accordance with SFAS No. 144, the results of operations related to the assets held for sale as of February 25, 2006, have been reclassified to discontinued operations in all periods presented. Summarized quarterly financial data for the years ended February 25, 2006 and February 26, 2005 are set forth below (in thousands except per share amounts):

Fiscal 2006	Three Months Ended			
	5/28/2005	8/27/2005	11/26/2005	2/25/2006
Net sales .....	\$390,314	\$423,675	\$456,690	\$506,022
Gross profit .....	137,485	135,102	167,316	161,787
Net income (loss) from continuing operations <sup>(1)</sup> .....	(8,456)	(6,373)	(5,657)	(6,985)
Net income (loss) from discontinued operations .....	(4,006)	(3,812)	(1,524)	(2,991)
Net income (loss) .....	(12,462)	(10,185)	(7,181)	(9,976)
Basic earnings (loss) per share from continuing operations .....	(.10)	(.07)	(.06)	(.08)
Diluted earnings (loss) per share from continuing operations .....	(.10)	(.07)	(.06)	(.08)
Basic earnings (loss) per share from discontinued operations .....	(.04)	(.05)	(.02)	(.03)
Diluted earnings (loss) per share from discontinued operations .....	(.04)	(.05)	(.02)	(.03)
Basic earnings (loss) per share .....	(.14)	(.12)	(.08)	(.11)
Diluted earnings (loss) per share .....	(.14)	(.12)	(.08)	(.11)

Fiscal 2005	Three Months Ended			
	5/29/2004	8/28/2004	11/27/2004	2/26/2005
Net sales .....	\$417,867	\$437,996	\$467,202	\$502,278
Gross profit .....	168,330	165,635	183,411	186,270
Net income (loss) from continuing operations <sup>(2)</sup> .....	13,984	12,858	18,583	17,340
Net income (loss) from discontinued operations .....	(2,247)	(2,412)	892	1,459
Net income (loss) .....	11,737	10,446	19,475	18,799
Basic earnings (loss) per share from continuing operations .....	.16	.15	.22	.20
Diluted earnings (loss) per share from continuing operations .....	.15	.15	.21	.20
Basic earnings (loss) per share from discontinued operations .....	(.03)	(.03)	.01	.02
Diluted earnings (loss) per share from discontinued operations .....	(.02)	(.03)	.01	.01
Basic earnings (loss) per share .....	.13	.12	.23	.22
Diluted earnings (loss) per share .....	.13	.12	.22	.21

<sup>(1)</sup> Net income for the fourth quarter ended February 25, 2006 included the pre-tax effect of a \$4.8 million impairment charge on long-lived store-level assets. Total impairment charges for fiscal year 2006 were \$5.8 million. See Note 1 of the Notes to Consolidated Financial Statements for further discussion of this charge.

<sup>(2)</sup> Net income for the fourth quarter and fiscal year ended February 26, 2005 included the pre-tax effect of a \$6.3 million charge related to operating leases for years prior to fiscal 2005. See Note 1 of the Notes to Consolidated Financial Statements for further discussion of this charge.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

**REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Management is responsible for establishing and maintaining a system of internal control over financial reporting designed to provide reasonable assurance that transactions are executed in accordance with management authorization and that such transactions are properly recorded and reported in the financial statements, and that records are maintained so as to permit preparation of the financial statements in accordance with U.S. generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Management has assessed the effectiveness of the Company's internal control over financial reporting utilizing the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control — Integrated Framework*. Management concluded that based on its assessment, Pier 1 Imports, Inc.'s internal control over financial reporting was effective as of February 25, 2006. Management's assessment of the effectiveness of the Company's internal control over financial reporting as of February 25, 2006 has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report which is included in this Annual Report on Form 10-K.

/s/ Marvin J. Girouard

Marvin J. Girouard  
Chairman of the Board and  
Chief Executive Officer

/s/ Charles H. Turner

Charles H. Turner  
Executive Vice President, Finance,  
Chief Financial Officer and Treasurer

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors of Pier 1 Imports, Inc.

We have audited management's assessment, included in the accompanying Report of Management on Internal Control over Financial Reporting, that Pier 1 Imports, Inc. maintained effective internal control over financial reporting as of February 25, 2006, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Pier 1 Imports, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Pier 1 Imports, Inc. maintained effective internal control over financial reporting as of February 25, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Pier 1 Imports, Inc. maintained, in all material respects, effective internal control over financial reporting as of February 25, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Pier 1 Imports, Inc. as of February 25, 2006 and February 26, 2005, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended February 25, 2006 and our report dated April 25, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Fort Worth, Texas  
April 25, 2006

During the fourth quarter of fiscal 2006, the Company added additional controls related to its procedures for gathering cash flow information related to its securitization of proprietary credit card receivables. There has been no other change in the Company's internal control over financial reporting during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

As required by Exchange Act Rules 13a-15 and 15d-15, an evaluation was conducted under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of February 25, 2006, and based on this evaluation the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of such date to ensure that information required to be disclosed by the Company in its reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

**Item 9B. Other Information.**

None.

**PART III**

**Item 10. Directors and Executive Officers of the Company.**

**Directors of the Company**

Information regarding directors of the Company required by this Item is incorporated by reference to the section entitled "Election of Directors — Nominees for Directors" set forth in the Company's Proxy Statement for its 2006 Annual Meeting of Shareholders.

The information regarding compliance with Section 16(a) of the Securities Exchange Act of 1934 required by this Item is incorporated by reference to the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" set forth in the Company's Proxy Statement for its 2006 Annual Meeting of Shareholders.

Information regarding the Company's audit committee financial experts and code of ethics and business conduct required by this item is incorporated by reference to the section entitled "Matters Relating to Corporate Governance, Board Structure, Director Compensation and Stock Ownership" set forth in the Company's Proxy Statement for its 2006 Annual Meeting of Shareholders.

No director or nominee for director of the Company has any family relationship with any other director or nominee or with any executive officer of the Company.

**Executive Officers of the Company**

MARVIN J. GIROUARD, age 66, has served as Chairman and Chief Executive Officer of the Company since March 1999 and has been a member of the Executive Committee since December 1998. He has been a Director of the Company since August 1988. From June 1998 to February 1999, Mr. Girouard served as President and Chief Executive Officer of the Company and from August 1988 to June 1998 he served as President and Chief Operating Officer of the Company. From May 1985 until August 1988, he served as Senior Vice President of Merchandising of Pier 1 Imports (U.S.), Inc.

CHARLES H. TURNER, age 49, has served as Executive Vice President of Finance since April 2002 and has served as Chief Financial Officer and Treasurer of the Company since August 1999. He served as Senior Vice President of Finance of the Company from August 1999 to April 2002. He served as Senior Vice President of Stores of the Company from August 1994 to August 1999, and served as Controller and Principal Accounting Officer of the Company from January 1992 to August 1994.

GREGORY S. HUMENESKY, age 54, has served as Executive Vice President of Human Resources of the Company since February 2005. Prior to joining the Company, he served as Senior Vice President of Human Resources at Zale Corporation from April 1996 to February 2005.

JAY R. JACOBS, age 51, has served as Executive Vice President of Merchandising of the Company since April 2002. He served as Senior Vice President of Merchandising of the Company from May 1995 to April 2002. He served as Vice President of Divisional Merchandising of Pier 1 Imports (U.S.), Inc. from May 1993 to May 1995, and served as Director of Divisional Merchandising of Pier 1 Imports (U.S.), Inc. from July 1991 to May 1993.

PHIL E. SCHNEIDER, age 54, has served as Executive Vice President of Marketing of the Company since April 2002. He served as Senior Vice President of Marketing of the Company from May 1993 to April 2002, and served as Vice President of Advertising of Pier 1 Imports (U.S.), Inc. from January 1988 to May 1993.

DAVID A. WALKER, age 55, has served as Executive Vice President of Logistics and Allocations of the Company since April 2002. He served as Senior Vice President of Logistics and Allocations of the Company from September 1999 to April 2002. He served as Vice President of Planning and Allocations of Pier 1 Imports (U.S.), Inc. from January 1994 to September 1999, and served as Director of Merchandise Services of Pier 1 Imports (U.S.), Inc. from October 1989 to January 1994.

E. MITCHELL WEATHERLY, age 58, has served as Executive Vice President of Stores of the Company since December 2004. He served as Executive Vice President of Human Resources of the Company from April 2002 to December 2004. He served as Senior Vice President of Human Resources of the Company from June 1992 to April 2002, and served as Vice President of Human Resources of the Company from June 1989 to June 1992 and of Pier 1 Imports (U.S.), Inc. from August 1985 to June 1992.

The officers of the Company are appointed by the Board of Directors, hold office until their successors are elected and qualified and/or until their earlier death, resignation or removal.

None of the above executive officers has any family relationship with any other of such officers or with any director of the Company. None of such officers was selected pursuant to any arrangement or understanding between him and any other person.

**Item 11. Executive Compensation.**

The information required by this Item is incorporated herein by reference to the section entitled "Executive Compensation" and the section entitled "Matters Relating to Corporate Governance, Board Structure, Director Compensation and Stock Ownership — Fees Paid to Directors" set forth in the Company's Proxy Statement for its 2006 Annual Meeting of Shareholders.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information required by this Item is incorporated by reference to the section entitled "Matters Relating to Corporate Governance, Board Structure, Director Compensation and Stock Ownership — Security Ownership of Management" and the section entitled "Executive Compensation — Equity Compensation Plan Information" set forth in the Company's Proxy Statement for its 2006 Annual Meeting of Shareholders.

**Item 13. Certain Relationships and Related Transactions.**

The information required by this Item is incorporated by reference to the section entitled "Compensation Committee Interlocks and Insider Participation; Certain Related Party Transactions" set forth in the Company's Proxy Statement for its 2006 Annual Meeting of Shareholders.

**Item 14. Principal Accounting Fees and Services.**

Information required by this Item is incorporated by reference to the sections entitled "Other Business — Independent Auditor Fees" and "Other Business — Pre-approval of Nonaudit Fees" set forth in the Company's Proxy Statement for its 2006 Annual Meeting of Shareholders.

**PART IV**

**Item 15. Exhibits, Financial Statement Schedules.**

(a) List of consolidated financial statements, schedules and exhibits filed as part of this report.

1. Financial Statements

Report of Independent Registered Public Accounting Firm

Consolidated Statements of Operations for the Years Ended February 25, 2006, February 26, 2005 and February 28, 2004

Consolidated Balance Sheets at February 25, 2006 and February 26, 2005

Consolidated Statements of Cash Flows for the Years Ended February 25, 2006, February 26, 2005 and February 28, 2004

Consolidated Statements of Shareholders' Equity for the Years Ended February 25, 2006, February 26, 2005 and February 28, 2004

Notes to Consolidated Financial Statements

2. Financial Statement Schedules

Schedules have been omitted because they are not required or are not applicable or because the information required to be set forth therein either is not material or is included in the financial statements or notes thereto.

3. Exhibits

See Exhibit Index.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PIER 1 IMPORTS, INC.

Date: April 24, 2006

By: /s/ Marvin J. Girouard

Marvin J. Girouard,  
Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Marvin J. Girouard</u> Marvin J. Girouard	Chairman and Chief Executive Officer	April 24, 2006
<u>/s/ Charles H. Turner</u> Charles H. Turner	Executive Vice President, Finance Chief Financial Officer and Treasurer	April 24, 2006
<u>/s/ Susan E. Barley</u> Susan E. Barley	Principal Accounting Officer	April 24, 2006
<u>/s/ John H. Burgoyne</u> John H. Burgoyne	Director	April 24, 2006
<u>/s/ Dr. Michael R. Ferrari</u> Dr. Michael R. Ferrari	Director	April 24, 2006
<u>/s/ James M. Hoak, Jr.</u> James M. Hoak, Jr.	Director	April 24, 2006
<u>/s/ Karen W. Katz</u> Karen W. Katz	Director	April 24, 2006
<u>/s/ Terry E. London</u> Terry E. London	Director	April 24, 2006
<u>/s/ Tom M. Thomas</u> Tom M. Thomas	Director	April 24, 2006



## EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Description</u>
3(i)	Certificate of Incorporation and Amendments thereto, incorporated herein by reference to Exhibit 3(i) to Registrant's Form 10-Q for the quarter ended May 30, 1998.
3(ii)	Bylaws of the Company as amended to date, incorporated herein by reference to Exhibit 3(ii) to Registrant's Form 10-K for the year ended February 26, 2005.
4.1	Indenture dated February 14, 2006 and Form of 6.375% Convertible Senior Notes due 2036, among Pier 1 Imports, Inc., the Subsidiary Guarantors parties thereto and JPMorgan Chase Bank, National Association, incorporated herein by reference to Exhibit 4.1 to the Company's Form 8-K filed February 16, 2006.
4.1.2	Registration Rights Agreement dated February 14, 2006, among Pier 1 Imports, Inc., the Guarantors parties thereto and the Initial Purchaser named therein, incorporated herein by reference to Exhibit 4.3 to the Company's Form 8-K filed February 16, 2006.
10.1*	Form of Indemnity Agreement between the Company and the directors and executive officers of the Company dated December 4, 2003, incorporated herein by reference to the Company's Form 10-K for the year ended February 28, 2004.
10.2*	The Company's Supplemental Executive Retirement Plan effective May 1, 1986, as amended and restated as of December 5, 2002, incorporated herein by reference to the Company's Form 10-K for the year ended February 26, 2005.
10.3*	The Company's Supplemental Retirement Plan effective September 28, 1995, as amended and restated as of December 5, 2002, incorporated herein by reference to the Company's Form 10-K for the year ended February 26, 2005.
10.3.1*	Amendment No. 1 to the Company's Supplemental Retirement Plan dated effective January 1, 2006, incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed December 21, 2005.
10.4.1*	The Company's Benefit Restoration Plan as amended and restated effective July 1, 1995, incorporated herein by reference to Exhibit 10.5.1 to the Company's Form 10-Q for the quarter ended May 27, 1995.
10.4.2*	Amendment Nos. 1, 2, 3, 4, 5 and 6 to the Company's Benefit Restoration Plan, incorporated herein by reference to the Company's Form 10-K for the year ended February 26, 2005.
10.5.1*	The Company's Management Restricted Stock Plan, as amended and restated effective June 30, 2005, incorporated herein by reference to Exhibit 10.5.1 to the Company's Form 10-Q for the quarter ended May 28, 2005.
10.5.2*	Form of Restricted Stock Agreement, incorporated herein by reference to the Company's Form 10-Q for the quarter ended May 28, 2005.
10.6.1*	The Company's 1989 Employee Stock Option Plan, amended and restated as of June 27, 1996, incorporated herein by reference to the Company's Form 10-K for the year ended February 26, 2005.
10.6.2*	Amendment No. 1 to the Company's 1989 Employee Stock Option Plan, incorporated herein by reference to the Company's Form 10-K for the year ended February 26, 2005.
10.7*	The Company's 1989 Non-Employee Director Stock Option Plan, as amended effective June 28, 1989, incorporated herein by reference to Exhibit 10(r) to the Company's Form 10-K for the fiscal year ended March 3, 1990.
10.8*	Form of Post-Employment Consulting Agreement between the Company and its executive officers, incorporated herein by reference to Exhibit 10(r) to the Company's Form 10-K for the fiscal year ended February 29, 1992.
10.9*	The Company's Management Medical and Tax Benefit Plans, incorporated herein by reference to Exhibit 10.18 to the Company's Form 10-K for the fiscal year ended February 26, 1994.
10.10.1	Pooling and Servicing Agreement, dated February 12, 1997, among Pier 1 Imports (U.S.), Inc., Pier 1 Funding, Inc. and Texas Commerce Bank National Association, as Trustee, incorporated herein by reference to Exhibit 10.13 to the Company's Form 10-K for the fiscal year ended March 1, 1997.

<u>Exhibit No.</u>	<u>Description</u>
10.10.2	Amendments Nos. 1, 2 and 3 to the Pooling and Servicing Agreement, incorporated herein by reference to Exhibit 10.13.2 to the Company's Form 10-K for the fiscal year ended February 28, 1998.
10.10.3	Amendment No. 4 to the Pooling and Servicing Agreement, incorporated herein by reference to Exhibit 10.11.3 to the Company's Form 10-K for the fiscal year ended March 3, 2001.
10.10.4	Amendment No. 5 to the Pooling and Servicing Agreement dated as of February 12, 1997 by and among Pier 1 Funding, L.L.C., Pier 1 Imports (U.S.), Inc., as servicer, and Wells Fargo Bank Minnesota, National Association as trustee, incorporated herein by reference to Exhibit 10.11.4 to the Company's Form 10-Q for the quarter ended September 1, 2001.
10.11*	Senior Management Bonus Plan restated as amended April 5, 2002, incorporated herein by reference to Appendix B, page B-1, of the Company's Proxy Statement for the fiscal year ended March 2, 2002.
10.12*	The Company's 1999 Stock Plan, as amended and restated as of June 25, 2004, incorporated herein by reference to Appendix C, page B-1, of the Company's Proxy Statement for the fiscal year ended February 28, 2004.
10.13*	Forms of Director and Employee Stock Option Agreements, incorporated herein by reference to Exhibit 10.2 to the Company's Form 10-Q for the quarter ended August 28, 1999.
10.14.1	Certificate Purchase Agreement among Pier 1 Funding, L.L.C., Pier 1 Imports (U.S.), Inc., the purchasers named therein and Morgan Guaranty Trust Company of New York, as administrative agent, incorporated herein by reference to Exhibit 10.17 to the Company's Form 10-Q for the quarter ended September 1, 2001.
10.14.2	Amendment Nos. 1, 2, 3 and 4 to the Certificate Purchase Agreement.
10.14.3	Fifth Amendment Agreement (Purchase Agreement) dated as of September 7, 2005 by and among Pier 1 Funding, L.L.C., Pier 1 Imports (U.S.), Inc., the Class A Purchasers and J.P. Morgan Chase Bank, N.A., as agent, incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed September 9, 2005.
10.14.4	Sixth Amendment Agreement (Purchase Agreement) dated as of September 19, 2005, by and among Pier 1 Funding, L.L.C., Pier 1 Imports (U.S.), Inc., the Class A Purchasers and J.P. Morgan Chase Bank, N.A., as agent, incorporated herein by reference to Exhibit 10.3 to the Company's Form 10-Q for the quarter ended August 27, 2005.
10.15	Repurchase Agreements relating to the cancellation of Series 1997-1 Class A Certificates, incorporated herein by reference to Exhibit 10.18 to the Company's Form 10-Q for the quarter ended September 1, 2001.
10.16*	The Company's Stock Purchase Plan, as amended June 25, 2004, incorporated herein by reference to Appendix C, page C-1, of the Company's Proxy Statement for the fiscal year ended February 28, 2004.
10.17*	Employment Agreement between Pier 1 Imports, Inc. and Gregory S. Humenesky, dated February 28, 2005, incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed March 3, 2005.
10.18.1	Series 2001-1 Supplement, dated as of September 4, 2001, as amended September 3, 2002, June 17, 2003, August 31, 2004, and February 22, 2005, by and among Pier 1 Funding, L.L.C., Pier 1 Imports (U.S.), Inc., and Wells Fargo Bank Minnesota, National Association as trustee.
10.18.2	Fifth Amendment Agreement (Supplement) dated as of September 7, 2005, by and among Pier 1 Funding, L.L.C., Pier 1 Imports (U.S.), Inc., and Wells Fargo Bank, Minnesota, National Association, as trustee, incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed September 9, 2005.
10.18.3	Sixth Amendment Agreement (Supplement) dated as of September 19, 2005, by and among Pier 1 Funding, L.L.C., Pier 1 Imports (U.S.), Inc., and Wells Fargo Bank, Minnesota, National Association, as trustee, incorporated herein by reference to Exhibit 10.4 to the Company's Form 10-Q for the quarter ended August 27, 2005.
10.18.4	Seventh Amendment Agreement dated as of February 6, 2006, by and among Pier 1 Funding, L.L.C., Pier 1 Imports (U.S.), Inc. and Wells Fargo Bank, National Association, as trustee, incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed February 7, 2006.

<u>Exhibit No.</u>	<u>Description</u>
10.18.5	Consent to Extension, effective as of March 9, 2006, incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed March 15, 2006.
10.18.6	Eighth Amendment Agreement dated as of March 13, 2006, by and among Pier 1 Funding, L.L.C., Pier 1 Imports (U.S.), Inc. and Wells Fargo Bank, National Association, as trustee, incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed March 15, 2006.
10.19	Secured Credit Agreement, dated November 22, 2005, among the Company, certain of its subsidiaries, Bank of America, N.A., Wells Fargo Retail Finance, LLC, Wachovia Bank, National Association, HSBC Bank USA, N.A., JPMorgan Chase Bank, N.A., and others, incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed November 23, 2005.
10.20	Pier 1 Umbrella Trust, dated December 21, 2005, incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed December 21, 2005.
10.21	Agreement for the Sale and Purchase of the Entire Issued Share Capital of The Pier Retail Group Limited dated March 20, 2006, by and among PIR Trading, Inc., Pier 1 Imports (U.S.), Inc., Palli Limited and Lagerinn ehf., incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed March 24, 2006.
21	Subsidiaries of the Company.
23	Consent of Independent Registered Public Accounting Firm.
31.1	Certification of the Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a).
31.2	Certification of the Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a).
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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\* Management Contracts and Compensatory Plans

Notice of Annual Meeting of Shareholders

# **Proxy Statement**



**Pier 1 imports®**

**2006 Annual Report**

**PIER 1 IMPORTS, INC.**

**100 Pier 1 Place  
Fort Worth, Texas 76102**

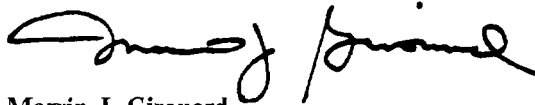
May 15, 2006

Dear Shareholder:

The Board of Directors and Management cordially invite you to attend Pier 1's annual meeting of shareholders to be held at 10:00 a.m., local time, on Thursday, June 22, 2006, at the Fort Worth Club, Trinity Room, 306 West 7th Street, Fort Worth, Texas. The formal notice of the annual meeting of shareholders and proxy statement are attached. Please read them carefully.

It is important that your shares be voted at the meeting in accordance with your preference. If you do not plan to attend, you may vote your proxy by telephone, Internet or mail. A toll-free telephone number and web site address are included on your proxy card. If you choose to vote by mail, please complete the proxy card located in the envelope's address window by indicating your vote on the issues presented and sign, date and return the proxy card in the prepaid envelope provided. If you are able to attend the meeting and wish to vote in person, you may withdraw your proxy at that time.

Sincerely,

A handwritten signature in black ink, appearing to read "Marvin J. Girouard", written over a horizontal line.

**Marvin J. Girouard**  
Chairman and Chief Executive Officer

**PIER 1 IMPORTS, INC.**

**100 Pier 1 Place  
Fort Worth, Texas 76102**

**NOTICE OF ANNUAL MEETING OF SHAREHOLDERS  
To Be Held June 22, 2006**

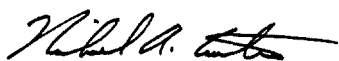
Pier 1's annual meeting of shareholders will be held on Thursday, June 22, 2006, at 10:00 a.m., local time, at the Fort Worth Club, Trinity Room, 306 West 7th Street, Fort Worth, Texas for the following purposes:

- (1) to elect seven directors to hold office until the next annual meeting of shareholders;
- (2) to vote on a proposal to approve the Pier 1 Imports, Inc. 2006 Stock Incentive Plan; and
- (3) to transact any other business as may properly come before the annual meeting or any adjournment.

Only shareholders of record at the close of business on April 24, 2006 will be entitled to vote at the annual meeting. A complete list of shareholders entitled to vote will be available for examination at Pier 1's offices at 100 Pier 1 Place, Fort Worth, Texas by any shareholder during ordinary business hours for a period of ten days prior to the date of the annual meeting.

To ensure that your vote will be counted, please complete, sign and date the enclosed proxy card and return it promptly in the enclosed prepaid envelope, whether or not you plan to attend the annual meeting. Also, the enclosed proxy card contains instructions on voting by telephone or by Internet instead of executing and returning the proxy card. You may revoke your proxy in the manner described in the accompanying proxy statement at any time before it has been voted at the annual meeting.

By Order of the Board of Directors,



**Michael A. Carter**  
Senior Vice President and General Counsel,  
Corporate Secretary

May 15, 2006  
Fort Worth, Texas

**PLEASE PROMPTLY SUBMIT YOUR PROXY BY MAIL,  
TELEPHONE OR INTERNET WHETHER OR NOT YOU INTEND  
TO BE PRESENT AT THE ANNUAL MEETING.**

# **PIER 1 IMPORTS, INC.**

**100 Pier 1 Place  
Fort Worth, Texas 76102**

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## **PROXY STATEMENT For ANNUAL MEETING OF SHAREHOLDERS**

**To Be Held June 22, 2006**

The board of directors of Pier 1 Imports, Inc. is soliciting proxies for the 2006 annual meeting of shareholders. You are receiving this proxy statement because you own shares of Pier 1 common stock that entitle you to vote at the meeting. By use of a proxy, you can vote on the matters to be decided at the meeting without actually attending the meeting in person. Simply complete, sign, date and return the enclosed proxy card in the envelope provided, and your shares will be voted at the meeting in accordance with your instructions. If you sign and return your proxy card with no instructions with respect to a matter to be voted on, your shares will be voted in accordance with the recommendation of the board of directors contained in this proxy statement. The proxy card also contains instructions on voting by telephone or by Internet instead of signing and returning the proxy card. Submitting your proxy by any of these methods will not affect your right to attend the meeting and vote in person.

If you submit your proxy but later decide to change or revoke the instructions you provided, you may do so at any time before the proxies are voted at the meeting by notifying Pier 1's corporate secretary in writing at 100 Pier 1 Place, Fort Worth, Texas 76102 that you wish to revoke your proxy, by delivering a subsequent proxy relating to the same shares, or by attending the annual meeting and voting in person. Please note, however, that attendance at the annual meeting will not, in and of itself, result in your proxy being revoked.

Pier 1 will begin sending this proxy statement and the enclosed proxy card to its shareholders on May 15, 2006.

### **ELECTION OF DIRECTORS**

The shareholders will elect seven directors at the annual meeting. In order to be elected, a nominee for director must receive the vote of a majority of the shares of common stock present in person or represented by proxy and entitled to vote at the meeting. Those elected will serve on the board until the next annual meeting and until their successors are elected and qualify. The board of directors has nominated each person listed below to stand for election.

The persons named in your proxy will vote your shares for the election of these nominees unless you withhold authority to vote for any of them. Although Pier 1 does not anticipate that any of the nominees will be unable or unwilling to serve as a director, in the event that is the case, the board may reduce its size or choose a substitute for that nominee. The board of directors recommends that you vote **"FOR"** each of the following nominees.

#### **Nominees for Directors**

##### **MARVIN J. GIROUARD**

Marvin J. Girouard, age 66, has been a director of Pier 1 since August 1988, has served as chairman and chief executive officer since March 1999 and has been a member of the executive committee since December 1998. From June 1998 to February 1999, Mr. Girouard served as Pier 1's president and chief executive officer and from August 1988 to June 1998, Mr. Girouard served as Pier 1's president and chief

operating officer. From May 1985 until August 1988, he served as senior vice president of merchandising of Pier 1 Imports (U.S.), Inc., one of Pier 1's wholly owned subsidiaries. He is also a director of Brinker International, Inc.

#### JAMES M. HOAK, JR.

James M. Hoak, Jr., age 62, has been a director of Pier 1 since September 1991 and is chairman of the nominating/corporate governance committee, chairman of the audit committee and a member of the executive committee. He has served as chairman of Hoak Media, LLC, a television broadcasting company, since its formation in August 2003. He also has served as chairman and a principal of Hoak Capital Corporation, a private equity investment firm, since September 1991. He served as chairman of Heritage Media Corporation, a broadcasting and marketing services firm, from its inception in August 1987 until its sale in August 1997. From February 1991 to January 1995, he served as chairman and chief executive officer of Crown Media, Inc., a cable television company. He is also a director of Chaparral Steel Company, Da-Lite Screen Company, Inc. and PanAmSat Corporation.

#### TOM M. THOMAS

Tom M. Thomas, age 64, has been a director of Pier 1 since September 1998, and is chairman of the executive committee, chairman of the compensation committee and a member of the nominating/corporate governance committee. Mr. Thomas has been a shareholder of Winstead Sechrest & Minick P.C., a law firm, since August 2005. From September 2001 to July 2005, he was a senior partner of Kolodey, Thomas & Blackwood, LLP, a law firm. He was also senior partner of Thomas & Culp, LLP, a law firm, from 1994 to August 2001.

#### JOHN H. BURGoyNE

John H. Burgoyne, age 64, has been a director of Pier 1 since February 1999 and is a member of the compensation committee. Mr. Burgoyne has served as president of Burgoyne and Associates, an international consulting firm, since March 1996. From May 1995 to March 1996, Mr. Burgoyne served as the general manager of IBM's Travel Industry sector for their Asia Pacific Region. Prior to that time, he served as the president and general manager of IBM China Corporation Ltd.

#### MICHAEL R. FERRARI

Michael R. Ferrari, age 66, has been a director of Pier 1 since February 1999 and is a member of the audit committee. He has served as senior vice president and managing director of the higher education practice of EFL Associates, an executive search firm, since May 2003. He is also the president of Ferrari and Associates LLC, a higher education consulting firm he established in May 2003. Dr. Ferrari was granted the title of Chancellor Emeritus of Texas Christian University by the university's board of trustees on June 1, 2003, and served as chancellor of T.C.U. and as professor of management in the M. J. Neeley School of Business at T.C.U. from July 1998 through May 2003. From 1985 to 1998, he served as president of Drake University.

#### KAREN W. KATZ

Karen W. Katz, age 49, has been a director of Pier 1 since June 2001 and is a member of the compensation committee and the nominating/corporate governance committee. She has served as president and chief executive officer of Neiman Marcus Stores since December 2002. From May 2000 to December 2002, she served as president and chief executive officer of Neiman Marcus Direct, a division of the Neiman Marcus Group. Prior to that time, she served as executive vice president of stores for Neiman Marcus Stores from February 1998 to May 2000 and senior vice president and director of stores of Neiman Marcus Stores from October 1996 to February 1998.



## **TERRY E. LONDON**

Terry E. London, age 56, has been a director of Pier 1 since September 2003 and is a member of the audit committee. He established London Partners LLC, a private equity investment firm, in August 2000 after serving as president and chief executive officer of Gaylord Entertainment Company, a specialty lodging and entertainment company, from May 1997 to August 2000. Prior to that time, he served as chief financial and administrative officer of Gaylord Entertainment from November 1991 to April 1997. He also serves as a director of Johnson Outdoors, Inc.

### **MATTERS RELATING TO CORPORATE GOVERNANCE, BOARD STRUCTURE, DIRECTOR COMPENSATION AND STOCK OWNERSHIP**

#### **Corporate Governance**

The board of directors believes very strongly that good corporate governance is a prerequisite to achieving business success. In June 2000, the board of directors adopted formal, written corporate governance guidelines, policies and procedures designed to strengthen Pier 1's corporate governance. In 2003, the board amended those guidelines to meet new requirements of the Securities and Exchange Commission and the New York Stock Exchange. Among other things, the enhanced guidelines contain standards for determining whether a director is independent, a code of business conduct and ethics applicable to all of Pier 1's directors, officers and employees and updated charters for each of the board's committees. The nominating/corporate governance committee is responsible for overseeing and reviewing the guidelines at least annually, and recommending any proposed changes to the full board for its approval. The Pier 1 Imports, Inc. Corporate Governance Guidelines, Code of Business Conduct and Ethics and charters for the audit, compensation and nominating/corporate governance committees are available on Pier 1's web site at [www.pier1.com](http://www.pier1.com) under the heading Investor Relations — Corporate Governance.

#### **Director Independence**

It is Pier 1's policy that the board of directors will at all times consist of a majority of independent directors. In addition, all members of the audit committee, compensation committee and nominating/corporate governance committee must be independent. To be considered independent, a director must satisfy the independence requirements established by the NYSE. The board will consider and apply all facts and circumstances relating to a director in determining whether that director is independent. The board has determined that six of the seven current members of the board of directors are independent. They are directors Hoak, Thomas, Burgoyne, Ferrari, Katz and London. In considering the independence of Mr. Thomas, the board considered all the relevant facts and circumstances, including Mr. Thomas' position as a shareholder of a law firm that performs legal services for Pier 1. Among the relevant facts and circumstances considered, it was noted that the fees paid to this law firm in fiscal year 2006 constituted less than 2% of the total fees paid by Pier 1 for legal services during that period; Mr. Thomas performs no legal services for Pier 1; Mr. Thomas is paid a predetermined salary pursuant to an employment agreement with this law firm, and his compensation from this law firm is in no way determined by or contingent upon the amount of legal fees Pier 1 pays to this firm; Mr. Thomas is not an executive officer of this law firm and beneficially owns substantially less than a 10% equity interest in this law firm; and the fees paid by Pier 1 to this law firm during the law firm's last fiscal year were substantially less than 2% of the law firm's gross revenues. Based upon these and the other relevant facts and circumstances considered, the board determined that the relationship between Pier 1 and the law firm of which Mr. Thomas is a shareholder is not a material relationship with Pier 1 as contemplated by the NYSE director independence rules and that Mr. Thomas continues to be an independent director under those rules.

## **Directors Attendance at Board and Committee Meetings and at the Annual Meeting of Shareholders**

Pier 1's board of directors met eight times during fiscal year 2006. Each director attended at least 75% of the total number of board meetings and meetings of the board committee or committees on which he or she served during fiscal year 2006. Although Pier 1 has no formal policy on the matter, all directors are encouraged to attend, and typically have attended, Pier 1's annual meeting of shareholders. Last year, all directors attended Pier 1's annual meeting of shareholders except Mrs. Katz who was out of the country.

## **Fees Paid to Directors**

Each director who was not a Pier 1 employee received the following cash compensation for services to the board during fiscal year 2006:

- a fee of \$33,000;
- \$1,750 for each board meeting attended in person;
- \$1,000 for each board meeting attended by telephone;
- \$750 for each committee meeting attended in person; and
- \$500 for each committee meeting attended by telephone.

The chairman of the audit committee and chairman of the compensation committee received additional compensation of \$12,500 during fiscal 2006. All of Pier 1's independent directors participate in Pier 1's Director Deferred Stock Program. That program provides that directors must defer one-half, and may choose to defer up to all, of their cash fees. Deferred fees are matched 50% by Pier 1 into an equivalent value of deferred stock units. Directors receive shares of Pier 1's common stock in exchange for their deferred stock units when they leave the board. Three directors deferred all of their cash fees last fiscal year, and three directors, Messrs. Burgoyne, London and Ferrari, deferred 50% of their cash fees for all or a part of last fiscal year. On March 23, 2006, the board of directors granted 5,000 deferred stock units to each of Messrs. Thomas and Hoak. The units were awarded in recognition of their efforts and service, in their role as members of the executive committee, in connection with the sale of The Pier Retail Group Limited, a former subsidiary of Pier 1, the convertible senior notes transaction which closed on February 14, 2006, and other matters. The awards were effective on April 3, 2006, and were in lieu of fees for certain executive committee meetings.

Each non-employee director also receives an annual grant under Pier 1's 1999 Stock Plan of stock options covering 6,000 shares of common stock which vest immediately. Directors who are Pier 1 employees do not receive any compensation for their board activities.

## **Board Committees**

There are four standing committees of the board of directors. They are the executive committee, the nominating/corporate governance committee, the audit committee and the compensation committee. A brief description of each committee's function, the number of meetings held last fiscal year and the names of the directors who are members of the committees follows.

*Executive Committee.* The executive committee directs and manages Pier 1's business and affairs in the intervals between board meetings. In doing so, the committee has all of the powers and authority of the full board in the management of Pier 1's business, except for powers or authority that may not be delegated to the committee as a matter of law or that are delegated by the board to another committee. The executive committee met on five occasions during the last fiscal year. Executive committee members are directors Thomas (chairman), Girouard and Hoak.

*Nominating/Corporate Governance Committee.* The nominating/corporate governance committee is responsible for considering and making recommendations to the board regarding nominees for election to the board and the membership of the various board committees. The committee is also responsible for

establishing and overseeing Pier 1's corporate governance guidelines. In fulfilling its purpose, the committee established and oversees the Pier 1 Imports, Inc. Corporate Governance Guidelines described earlier in this proxy statement and the Director Nomination Process which is set forth below. The nominating/corporate governance committee met on two occasions during the last fiscal year. Committee members are directors Hoak (chairman), Thomas and Katz.

***Audit Committee.*** The audit committee provides assistance to the board in overseeing Pier 1's accounting, auditing, financial reporting and systems of internal controls regarding finance and accounting. As part of its duties, the audit committee is directly responsible for the appointment, compensation, retention and oversight of Pier 1's independent auditors. The committee also reviews Pier 1's quarterly and year-end financial statements. The audit committee held 11 meetings during the last fiscal year. Audit committee members are directors Hoak (chairman), Ferrari and London. The board of directors has determined that each member of the audit committee is an audit committee financial expert, as defined by the SEC, and has accounting or related financial management expertise within the meaning of NYSE listing standards.

***Compensation Committee.*** The compensation committee recommends to the board adopting or amending Pier 1's incentive-based compensation plans and sets compensation for Pier 1's chief executive officer and executive vice presidents. It also oversees the administration of the incentive plans and other compensation and benefit plans and recommends to the board compensation of Pier 1's directors and changes in or the establishment of compensation and benefit plans for Pier 1's employees. The committee held six meetings during the last fiscal year. Compensation committee members are directors Thomas (chairman), Burgoyne and Katz.

#### **Meetings of Independent Directors without Management Present**

To empower Pier 1's independent directors to serve as a more effective check on management, the independent directors meet at regularly scheduled executive sessions without members of Pier 1's management present. The independent directors met without management present six times last fiscal year. The chairman of the executive committee presides over these meetings.

#### **Procedures for Communicating with Directors**

The board of directors has established a process by which shareholders can send communications to board members. Shareholders can send written communications to one or more members of Pier 1's board, addressed to:

[Name of Board Member], Board of Directors  
Pier 1 Imports, Inc.  
c/o Corporate Secretary  
100 Pier 1 Place  
Fort Worth, Texas 76102

In addition, you may communicate with the chairman of the audit committee, compensation committee and nominating/corporate governance committee by sending an email to [auditchair@pier1.com](mailto:auditchair@pier1.com), [compchair@pier1.com](mailto:compchair@pier1.com), or [corpgovchair@pier1.com](mailto:corpgovchair@pier1.com), respectively, as well as the independent directors as a group by sending an email to [independentdirectors@pier1.com](mailto:independentdirectors@pier1.com).

Communications are distributed to the board or to the individual director or directors, as appropriate, depending on the subject matter and facts and circumstances outlined in the communication. Communications that are not related to the duties and responsibilities of the board will not be distributed, including:

- spam;
- junkmail and mass mailings;
- product complaints;

- product inquiries;
- new product suggestions;
- resumes and other forms of job inquiries;
- surveys; and
- business solicitations or advertisements.

In addition, Pier 1 will not distribute unsuitable material to its directors, including material that is unduly hostile, threatening or illegal, although any communication that is filtered out is available to any independent director upon request.

## **Director Nomination Process**

### ***Board Member Qualification Criteria***

The nominating/corporate governance committee has adopted *Board Member Qualification Criteria* which set forth the attributes and qualifications considered by the committee in evaluating nominees for director. The primary qualities and characteristics the committee looks for in nominees for director are:

- management and leadership experience;
- relevant knowledge and diversity of background and experience; and
- personal and professional ethics, integrity and professionalism.

The committee also believes that the board should be composed of individuals who have achieved a high level of distinction in business, law, education or public service and who possess one or more of the following specific qualities or skills:

- financial expertise;
- general knowledge of the retail industry;
- information technology experience;
- international business experience; and
- CEO, CFO or other senior management experience.

### ***Internal Process for Identifying Candidates***

Members of the nominating/corporate governance committee or other Pier 1 directors or executive officers may, from time to time, identify potential candidates for nomination to Pier 1's board. All proposed nominees, including candidates recommended for nomination by shareholders in accordance with the procedures described below, will be evaluated in light of the *Board Member Qualification Criteria* and the projected needs of the board at the time. As set forth in the committee's charter, the committee may retain a search firm to assist in identifying potential candidates for nomination to the board of directors. The search firm's responsibilities may include identifying and evaluating candidates believed to possess the qualities and characteristics set forth in the *Board Member Qualification Criteria*, as well as providing background information on potential nominees and interviewing and screening nominees if requested to do so by the committee.

### ***Shareholder Recommendations for Directors***

The nominating/corporate governance committee will consider candidates recommended by shareholders for election to Pier 1's board. A shareholder who wishes to recommend a candidate for evaluation by the committee should forward the candidate's name, business or residence address, principal occupation or employment and a description of the candidate's qualifications to the Chairman of the Nominating/

Corporate Governance Committee, in care of the Corporate Secretary, Pier 1 Imports, Inc., 100 Pier 1 Place, Fort Worth, Texas 76102.

In order for a candidate proposed by a shareholder to be considered by the committee for inclusion as a board nominee at the 2007 annual meeting of shareholders, the candidate must meet the *Board Member Qualification Criteria* described above and must be expressly interested and willing to serve as a Pier 1 director. In addition, the corporate secretary must receive the request for consideration and all required information no later than 5:00 p.m., local time, on January 15, 2007. Proposals should be sent via registered, certified or express mail. The corporate secretary will send properly submitted shareholder recommendations to the chairman of the committee. Individuals recommended to the committee by shareholders in accordance with these procedures will be evaluated by the committee in the same manner as individuals who are recommended through other means.

#### ***Shareholder Nominations of Directors***

Pier 1's by-laws also permit a shareholder to propose a candidate at an annual meeting of shareholders who is not otherwise nominated by the board of directors through the process described above if the shareholder complies with the advance notice, information and consent provisions contained in the by-laws. To comply with the advance notice provision of the by-laws, a shareholder who wishes to nominate a director at the 2007 annual meeting must provide Pier 1 written notice no earlier than March 24, 2007 and no later than April 23, 2007. You may contact Pier 1's corporate secretary to obtain the specific information that must be provided with the advance notice.

#### ***Nominees for Election at the 2006 Annual Meeting***

No nominees for election to the board of directors at Pier 1's 2006 annual meeting of shareholders were submitted by shareholders.

#### **Security Ownership of Management**

The following table indicates the ownership of Pier 1's common stock by each director and nominee, each executive officer named in the Summary Compensation Table, and all directors and executive officers as a group, as of April 24, 2006:

<u>Name</u>	<u>Shares Beneficially Owned (1) (2)</u>	<u>Percent of Class</u>
John H. Burgoyne .....	51,437	*
Michael R. Ferrari .....	49,900	*
Marvin J. Girouard .....	3,099,413 (3)	3.5%
James M. Hoak, Jr. ....	164,939	*
Jay R. Jacobs .....	452,437	*
Karen W. Katz .....	35,000	*
Terry E. London .....	17,000	*
Phil E. Schneider .....	676,789	*
Tom M. Thomas .....	18,000	*
Charles H. Turner .....	551,418	*
David A. Walker .....	534,557	*
E. Mitchell Weatherly .....	647,238	*
All directors and executive officers as a group .....	6,317,602	6.9%

- (1) The table includes shares acquired through and held by Pier 1's Stock Purchase Plan through April 24, 2006. The table also includes shares issuable within 60 days of April 24, 2006 to Mr. Burgoyne (47,000 shares), Mr. Ferrari (47,000 shares), Mr. Girouard (2,161,250 shares),

Mr. Hoak (62,250 shares), Mr. Jacobs (427,500 shares), Mrs. Katz (35,000 shares), Mr. London (17,000 shares), Mr. Schneider (621,000 shares), Mr. Thomas (18,000 shares), Mr. Turner (507,000 shares), Mr. Walker (496,300 shares), Mr. Weatherly (612,000 shares) and to all directors and executive officers as a group (5,052,550 shares), upon the exercise of stock options granted pursuant to Pier 1's stock option plans.

- (2) Unless otherwise indicated, the beneficial owner has sole voting and investment power with respect to his or her shares.
- (3) Includes 938,163 shares owned beneficially with sole voting power only.

\* Represents less than 1% of the outstanding shares of the class.

#### Security Ownership of Certain Beneficial Owners

The following table indicates the ownership by each person who is known by Pier 1 as of April 24, 2006 to own beneficially 5% or more of Pier 1's common stock:

<u>Name and Address of Beneficial Owner</u>	<u>Shares Beneficially Owned</u>	<u>Percent of Class</u>
FMR Corp. .... 82 Devonshire Street Boston, MA 02109	13,013,030(1)	14.99%
Royce & Associates, LLC .... 1414 Avenue of the Americas New York, NY 10019	10,065,200(2)	11.59%
Jakup a Dul Jacobsen .... Sundaborg 7 Reykjavik, Iceland	8,594,200(3)	9.9%
Franklin Resources, Inc. .... One Franklin Parkway San Mateo, CA 94403	5,572,230(4)	6.4%

- (1) The beneficial owner has sole voting power over 562,900 of the shares listed and sole dispositive power over all of the shares listed. This information was obtained from the beneficial owner's Schedule 13G (Amendment No. 1) filed with the Securities and Exchange Commission on April 10, 2006.
- (2) The beneficial owner has sole voting power and sole dispositive power over all of the shares listed. This information was obtained from the beneficial owner's Schedule 13G (Amendment No. 2) filed with the Securities and Exchange Commission on January 31, 2006.
- (3) This information was obtained from a Schedule 13D (Amendment No. 1) filed with the Securities and Exchange Commission on March 22, 2006 by Jakup a Dul Jacobsen, Lagerinn ehf and Kaupthing Bank hf. as beneficial owners of the shares listed. The filing indicates that the beneficial owners Jakup a Dul Jacobsen and Lagerinn ehf have shared voting power and shared dispositive power over all the shares listed and Kaupthing Bank has shared voting power and shared dispositive power over 4,251,800 of the shares listed.
- (4) This information was obtained from a Schedule 13G filed with the Securities and Exchange Commission on February 13, 2006 by Franklin Resources, Inc., Charles B. Johnson and Rupert H. Johnson, Jr. as beneficial owners of the shares listed. The filing indicates that Franklin Resources, Inc., Charles B. Johnson and Rupert H. Johnson, Jr. have no sole or shared voting power and no sole or shared dispositive power over any of the shares listed. However, certain subsidiaries of Franklin Resources, Inc. beneficially own all of the shares listed and have the following voting and dispositive power: Franklin Templeton Investments Corp. has sole voting power over 2,161,200 of the shares listed, sole dispositive power over 2,152,450 of the shares listed, and shared dispositive power over 8,750 of the shares listed; Franklin Advisory Services, LLC has sole voting power over 1,587,600 of

the shares listed and sole dispositive power over 1,595,100 of the shares listed; Templeton Investment Counsel, LLC has sole voting power and sole dispositive power over 1,480,520 of the shares listed; Franklin Templeton Investment Management Limited has sole voting power and sole dispositive power over 272,420 of the shares listed; and Templeton Global Advisors Limited has sole voting power and sole dispositive power over 62,990 of the shares listed.

## SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934 requires Pier 1's directors and executive officers, and persons who own more than 10% of a registered class of Pier 1's equity securities, to file with the SEC and the NYSE reports disclosing their ownership and changes in ownership of Pier 1's common stock or other equity securities. Pier 1's officers, directors and greater than 10% shareholders are required by SEC regulations to furnish Pier 1 with copies of all Section 16(a) forms they file. To Pier 1's knowledge, all Section 16(a) filing requirements applicable to Pier 1's officers, directors and greater than 10% beneficial owners during the last fiscal year were observed.

## EXECUTIVE COMPENSATION

The following table sets forth a summary of the compensation with respect to the past three fiscal years for services rendered in all capacities to Pier 1 and its subsidiaries by Pier 1's chief executive officer and five other most highly compensated executive officers.

**Summary Compensation Table**

Name and Principal Position	Fiscal Year	Annual Compensation			Long-Term Compensation		All Other Compensation(3)
		Salary	Bonus	Other Annual Compensation(1)	Restricted Stock Awards(2)	Securities Underlying Options (#)	
Marvin J. Girouard . . . . .	2006	\$1,000,000	\$—	\$166,126	\$ —	200,000	\$242,829
Chairman and Chief	2005	1,000,000	—	57,239	—	300,000	235,466
Executive Officer	2004	950,000	—	97,633	—	300,000	331,021
Charles H. Turner . . . . .	2006	365,000	—	27,368	256,500	20,000	36,475
Executive Vice President,	2005	365,000	—	54,290	—	100,000	37,114
Finance, Chief Financial	2004	345,000	—	28,751	—	100,000	32,921
Officer and Treasurer							
Jay R. Jacobs . . . . .	2006	365,000	—	33,998	256,500	20,000	45,072
Executive Vice President,	2005	365,000	—	31,169	—	100,000	43,494
Merchandising	2004	345,000	—	39,247	—	100,000	40,873
E. Mitchell Weatherly . . . . .	2006	325,000	—	29,293	256,500	20,000	40,979
Executive Vice	2005	280,000	—	47,754	—	100,000	36,014
President, Stores	2004	265,000	—	35,364	—	100,000	31,801
Phil E. Schneider . . . . .	2006	275,000	—	38,853	256,500	20,000	31,023
Executive Vice	2005	275,000	—	28,613	—	100,000	31,182
President, Marketing	2004	260,000	—	36,420	—	100,000	28,468
David A. Walker . . . . .	2006	275,000	—	25,669	256,500	20,000	25,271
Executive Vice President,	2005	275,000	—	25,729	—	100,000	25,421
Logistics and Allocations	2004	260,000	—	27,546	—	100,000	25,014

- (1) Includes reimbursements for club dues, automobile expenses, financial planning expenses, medical expenses, granting of cash awards, and tax reimbursements. Except for amounts paid to Messrs. Turner and Weatherly in fiscal year 2005, the total amount of perquisites paid to each named executive officer did not exceed the lesser of \$50,000 or 10% of such executive's salary and bonus for each fiscal year reported. During fiscal year 2005, Pier 1 reimbursed Mr. Turner \$10,800 for automobile expenses and \$19,998 for medical expenses and Mr. Weatherly \$10,800 for automobile expenses and \$16,433 for medical expenses.
- (2) Dollar value of restricted stock is computed using the closing market price of the common stock on the date of grant of the restricted stock. Recipients of such restricted stock awards will receive cash

dividends paid on such stock. The restricted stock grants for the 2006 fiscal year to Messrs. Turner (18,000 shares), Jacobs (18,000 shares), Weatherly (18,000 shares), Schneider (18,000 shares) and Walker (18,000 shares) will vest 33% on the first anniversary of the date of grant, 33% on the second anniversary of the date of grant and 34% on the third anniversary of the date of grant. The total amount and dollar value of restricted stock held at February 25, 2006, were Mr. Turner 18,000 shares (\$189,180), Mr. Jacobs 18,000 shares (\$189,180), Mr. Weatherly 18,000 shares (\$189,180), Mr. Schneider 18,000 shares (\$189,180) and Mr. Walker 18,000 shares (\$189,180).

- (3) Includes in fiscal year 2006 Pier 1's matching contributions accrued under Pier 1's 401(k) Retirement Plan of \$6,300 for Mr. Girouard, \$6,300 for Mr. Turner, \$6,300 for Mr. Jacobs, \$6,560 for Mr. Weatherly, \$5,500 for Mr. Schneider and \$4,125 for Mr. Walker; matching contributions accrued under Pier 1's Benefit Restoration Plans of \$30,000 for Mr. Girouard, \$7,019 for Mr. Turner, \$10,950 for Mr. Jacobs, \$9,750 for Mr. Weatherly, \$8,250 for Mr. Schneider and \$8,250 for Mr. Walker; matching contributions accrued under Pier 1's Stock Purchase Plan of \$100,000 for Mr. Girouard, \$18,250 for Mr. Turner, \$18,250 for Mr. Jacobs, \$16,250 for Mr. Weatherly, \$8,250 for Mr. Schneider and \$6,500 for Mr. Walker; above-market earnings accrued on the Benefit Restoration Plan of \$56,587 for Mr. Girouard, \$4,906 for Mr. Turner, \$9,572 for Mr. Jacobs, \$8,419 for Mr. Weatherly, \$9,023 for Mr. Schneider and \$6,396 for Mr. Walker; and above-market earnings on compensation deferred by Mr. Girouard of \$49,942.

#### **Employment Related Contracts, Severance and Change-in-Control Agreements.**

Pier 1 has entered into Post-Employment Consulting Agreements with Messrs. Girouard, Turner, Jacobs, Weatherly, Schneider and Walker. Those agreements provide that if Pier 1 terminates the executive's employment prior to retirement other than for "cause", or if the executive terminates his employment with Pier 1 for "good reason", as defined in the agreements, Pier 1 will retain the executive as a consultant for up to two years, depending on the executive's number of years of service as an officer, and will pay the executive a monthly consulting fee equal to one-twelfth of his annual base salary immediately prior to his termination. Pier 1 will also pay the executive 50% of his cost for continuing medical and dental insurance coverage. If the executive enters into employment during the consulting period that provides compensation equal to or greater than the amount of the consulting fees, Pier 1 will pay the executive an immediate one-time payment in the amount of 50% of the difference between the total fees that otherwise would have been payable during the term of the consulting agreement and the aggregate fees actually paid prior to reemployment. If the executive enters into employment during the consulting period that provides compensation less than the consulting fees, Pier 1 will reduce the monthly consulting fee by the amount of the monthly compensation for reemployment, and at the end of the consulting period will pay the executive 50% of the difference between the total fees that otherwise would have been payable during the term of the consulting agreement and the aggregate fees actually paid.

Pier 1 also has two supplemental retirement plans to aid in attracting and retaining key executives. Messrs. Girouard and Weatherly are fully vested in a plan, adopted by Pier 1 in 1986, which provides that upon death, disability, termination of employment within 24 months of a Change of Control, as defined in the plan, of Pier 1 (other than a termination for "cause", by the participant other than for "good reason" and certain other reasons as defined in the plan), retirement or other termination (commencing no earlier than at retirement age of 65), a participant will receive annual benefits over a period of 15 years (or a discounted lump-sum at the time of retirement in lieu of annual benefits) which, when added to Social Security retirement benefits, generally equal his target percentage of 50% of the average of his highest annual salary and bonus for any three years, increased by 6% per year for 15 years. If a participant has at least 10 years of plan participation and retires at or after age 55 and before age 65, his benefit is reduced by 5% for each year his retirement precedes age 65. If a participant retires after age 65, the percentage of his highest average annual salary and bonus (prior to age 65) used to calculate his benefit is increased above 50% by 5% for each year of service after age 65, to a total not greater than 65%. In addition to the benefits described above, each participant in the plan in the event of termination of employment has the right to participate, during the 15 years after the participant reaches age 65, in any major medical and



hospitalization insurance coverage made available generally to Pier 1 employees and their dependents. In the event of retirement, including retirement as a result of a Change of Control, with respect to each participant who is actively employed by Pier 1 after December 5, 2002, such participant has the right to participate during his lifetime in any major medical and hospitalization insurance coverage made available generally to Pier 1 employees and dependents.

The following table shows, for various levels of average annual compensation, the computed annual benefit and the alternative lump-sum benefit, payable at age 65, discounted at a rate equal to the lesser of the Pension Benefit Guaranty Corporation interest rate for immediate annuities (PBGC rate) or a 24-month rolling average of the PBGC rate, and less a calculated Social Security retirement benefit.

<u>Average Annual Compensation</u>	<u>Annual Benefit</u>	<u>Computed Lump-Sum Benefit</u>
\$ 300,000 .....	\$ 206,654	\$ 2,530,627
400,000 .....	284,240	3,480,732
500,000 .....	361,827	4,430,837
600,000 .....	439,413	5,380,943
700,000 .....	517,000	6,331,048
800,000 .....	594,586	7,281,154
1,000,000 .....	749,760	9,181,365
1,200,000 .....	904,933	11,081,575
1,500,000 .....	1,137,692	13,931,891
1,600,000 .....	1,215,279	14,881,997
1,800,000 .....	1,370,452	16,782,208
2,000,000 .....	1,525,625	18,682,418
2,200,000 .....	1,680,798	20,582,629
2,400,000 .....	1,835,971	22,482,840

The applicable average annual compensation as determined under the plan for Mr. Girouard is \$2,312,125 and for Mr. Weatherly is \$501,458. All participants in the plan have elected to receive benefits in a lump-sum distribution rather than annual benefits.

Pier 1 established a trust to hold funds to settle obligations under this plan. The trust assets are consolidated in Pier 1's financial statements and consist of interest yielding investments aggregating \$22,379,000 at February 25, 2006. These investments are restricted and may only be used to satisfy retirement obligations under the plan, which are expected to aggregate approximately \$34,912,077 through fiscal year 2016. Contributions to the trust are made at the discretion of the compensation committee.

Messrs. Turner, Jacobs, Schneider and Walker and one other executive officer participate in a supplemental retirement plan adopted by Pier 1 in 1995, which provides that upon death, disability, retirement (including retirement as a result of a Change of Control, as defined in the plan, of Pier 1 [other than a termination for "cause" by the participant, other than for "good reason" and certain other reasons as defined in the plan]) or other termination (not for "cause" and commencing no earlier than at retirement age of 65), a participant will receive a life annuity based on annual benefits which, when added to Social Security retirement benefits, generally equal a percentage (not to exceed a maximum of 60%) of the participant's highest average annual salary and bonus (based on a three-year average). If a participant has at least 10 years of plan participation and retires at or after age 55 and before age 65, his benefit is reduced by 5% for each year his retirement precedes age 65. Benefits vest for each participant at the rate of 10% per year of participation in the plan. Further, benefits accrue for each participant at a rate of 5% per year of credited service with Pier 1. The years of participation in the plan are: for Mr. Turner 10 years, for Mr. Jacobs 10 years, for Mr. Schneider 10 years and for Mr. Walker 5 years; and the years

of credited service are: for Mr. Turner 15 years, for Mr. Jacobs 29 years, for Mr. Schneider 21 years and for Mr. Walker 37 years. In addition to the benefits described above, each participant in this plan in the event of termination of employment, other than for cause, has the right to participate, during the 15 years after the participant reaches age 65, in any major medical and hospitalization insurance coverage made available generally to Pier 1 employees and their dependents. In the event of retirement, including retirement as a result of a Change of Control, with respect to each participant who is actively employed by Pier 1 after December 5, 2002, such participant has the right to participate during his or her lifetime in any major medical and hospitalization insurance coverage made available generally to Pier 1 employees and dependents. Retirement obligations under this plan are expected to aggregate approximately \$1,022,417 through fiscal year 2016.

The following table shows for various levels of average annual compensation the computed annual benefit payable at age 65 including current maximum annual Social Security retirement benefits.

<u>Average Annual Compensation</u>	<u>Computed Annual Benefit (1)</u>
\$ 300,000 .....	\$ 180,000
400,000 .....	240,000
500,000 .....	300,000
600,000 .....	360,000
700,000 .....	420,000
800,000 .....	480,000
1,000,000 .....	600,000
1,200,000 .....	720,000
1,500,000 .....	900,000
1,600,000 .....	960,000
1,800,000 .....	1,080,000
2,000,000 .....	1,200,000

(1) Assuming full vesting and accrual.

The applicable average annual compensation for Mr. Turner is \$681,333, for Mr. Jacobs is \$681,333, for Mr. Schneider is \$500,583 and for Mr. Walker is \$493,833.

Pier 1's 1999 Stock Plan provides that options granted to employees under the plan, including the named executive officers, immediately become fully exercisable in the event of a Change of Control, as defined in the plan, unless the board of directors determines otherwise prior to the Change of Control.

#### Option Grants in the Last Fiscal Year

The following table sets forth information relating to stock options granted during the fiscal year ended February 25, 2006 to the executive officers named in the Summary Compensation Table.

<u>Name</u>	<u>Number of Securities Underlying Options Granted (1)</u>	<u>% of Total Options Granted to Employees in Fiscal Year</u>	<u>Exercise Price (per share) (2)</u>	<u>Expiration Date</u>	<u>Grant Date Present Value (3)</u>
Marvin J. Girouard . . . .	200,000	13.88%	\$14.25	07/01/15	\$950,000
Charles H. Turner . . . . .	20,000	1.39	14.25	07/01/15	95,000
Jay R. Jacobs . . . . .	20,000	1.39	14.25	07/01/15	95,000
E. Mitchell Weatherly . . . . .	20,000	1.39	14.25	07/01/15	95,000
Phil E. Schneider . . . . .	20,000	1.39	14.25	07/01/15	95,000
David A. Walker . . . . .	20,000	1.39	14.25	07/01/15	95,000

- (1) All options were granted on July 1, 2005 and become exercisable in annual installments of 25% on each of the four anniversaries of the date of grant, except that all options become fully exercisable upon retirement, death, disability and certain "change in control" events. The administrative committee of the stock option plan may permit an employee to tender previously owned shares to pay the exercise price of an option and may permit an employee to satisfy his income tax withholding obligations up to the minimum statutory rate by the delivery of previously owned shares or the withholding of shares otherwise issuable upon exercise of the option. Options will terminate at the time of termination of employment if the termination is for "cause" or for resignation without Pier 1's consent; or the earlier of expiration of the option term or three months after termination in the case of any other termination, one year after death or disability, or three years after retirement.
- (2) Exercise price is equal to the current market value at the date of grant.
- (3) The present value of options on the date of grant was determined using a variation of the Black-Scholes option pricing model. The estimated values under the Black-Scholes option pricing model are based on the following assumptions at the time of grant: an exercise price equal to the fair market value of the underlying common stock; option term of five years; interest rate of 3.84%, which represents the interest rate at such option grant date of U.S. treasury securities having a five-year maturity; an expected dividend yield of 2.2% per year and a projected stock price volatility factor of 40%, which is estimated based on Pier 1's historical common stock prices. For purposes of determining these option valuations, a term of 5 years was used for the length of the option term rather than the actual ten-year option term. Five years approximates the historical average length of time from grant date to exercise date for all options previously granted by Pier 1. These assumptions were made as of the time of grant and may or may not be valid assumptions at later points in time. The actual value, if any, that an executive may realize from the options will be the excess of the market price of Pier 1's common stock on the day of exercising the options over the exercise price of the options. The actual value may differ significantly from the value estimated in the table.

#### Aggregate Option Exercises in the Last Fiscal Year and Fiscal Year-End Option Values

The following table provides information relating to the exercise of stock options by the executive officers named in the Summary Compensation Table during the last fiscal year, and the number and value of exercisable and unexercisable stock options held by those officers at February 25, 2006.

Name	Shares Acquired on Exercise	Value Realized (1)	Number of Securities Underlying Unexercised Options at Fiscal Year-End		Value of Unexercised In-the-Money Options at Fiscal Year-End (2)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Marvin J. Girouard . . . . .	—	\$ —	2,161,250	200,000	\$2,709,984	\$—
Charles H. Turner . . . . .	—	—	507,000	20,000	173,100	—
Jay R. Jacobs . . . . .	—	—	427,500	20,000	187,088	—
E. Mitchell Weatherly . . . .	—	—	612,000	20,000	524,525	—
Phil E. Schneider . . . . .	—	—	621,000	20,000	664,975	—
David A. Walker . . . . .	25,000	188,888	496,300	20,000	366,976	—

- (1) Computed as the difference between the option exercise prices and the market price of the common stock at the date of exercise.
- (2) Computed as the difference between the option exercise prices and \$10.51 (the closing price of the common stock at fiscal year-end).

## Equity Compensation Plan Information

The following table sets forth certain information regarding Pier 1's equity compensation plans as of February 25, 2006.

<u>Plan Category</u>	<u>Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights(1)</u>	<u>Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights(1)</u>	<u>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in the First Column) (2)</u>
Equity compensation plans approved by shareholders .....	12,738,025	\$15.41	555,794
Equity compensation plans not approved by shareholders(3) ..	N/A	N/A	N/A
Total:.....	12,738,025	\$15.41	555,794

- (1) Pier 1 has not granted warrants or rights applicable to this chart.
- (2) Includes 65,592 shares which may be awarded under the terms of Pier 1's Management Restricted Stock Plan. Pier 1's Stock Purchase Plan permits all participants to elect to have up to 10% of their compensation deducted and used to purchase Pier 1 common stock monthly at market values. Pier 1 provides matching contributions of 10% to 50% of each participant's deduction, depending on the participant's length of service, except that any participant who received contributions at a rate of 50% or more at the close of business on October 31, 1985 remains at that rate. There is no limit as to the number of shares that can be purchased under the Stock Purchase Plan.
- (3) Pier 1 does not have any equity compensation plans which have not been approved by its shareholders.

## COMPENSATION COMMITTEE REPORT ON EXECUTIVE COMPENSATION

Pier 1's compensation committee is composed of directors Thomas, Burgoyne and Katz. Each member of the compensation committee is an independent director as defined in the listing standards of the NYSE. The committee oversees Pier 1's incentive-based compensation plans and makes recommendations to the full board on establishing and amending incentive-based compensation plans and on matters relating to other compensation and benefit plans for Pier 1's chief executive officer and executive vice presidents. These responsibilities are reflected in the committee's charter, which is periodically reviewed and revised by the board and the committee. In fulfilling its responsibilities, the committee has the authority to engage an outside consulting firm or firms to assist in its evaluation of compensation. In fiscal year 2006, Pier 1 employed Hewitt Associates to conduct a study of the compensation paid to Pier 1's chief executive officer and executive vice presidents. The study included comparisons of base pay, annual incentive targets and long-term awards provided for these executives to a peer group of companies. The committee determined that the chief executive officer and executive vice presidents would not receive a base pay increase for fiscal year 2006, except that Mr. Weatherly received an increase in base salary due to his promotion from Executive Vice President, Human Resources to Executive Vice President, Stores.

Pier 1's overall philosophy on management compensation is that senior executives' compensation should be structured in a way that provides strong incentives for long-term success and performance. In addition to base salary, executive compensation may include a bonus, stock options, restricted stock, benefits and perquisites. Pier 1's incentive programs include both short-term bonus plans to reward annual performance and long-term, stock-based plans to reward increases in shareholder value and to align management's interests with those of Pier 1's shareholders. Pier 1's goal is to have more than half of potential senior executive compensation come from Pier 1's performance-based compensation plans. As a senior executive's level of responsibility increases, a greater portion of that executive's potential compensation comes from performance-based programs, with larger percentages of potential compensation directly related to the price of Pier 1's common stock.

When determining senior executives' compensation, the committee also considers the effect of limitations on deductibility of compensation for federal income tax purposes. Section 162(m) of the Internal Revenue Code generally prohibits public companies like Pier 1 from deducting from corporate income all compensation paid to the chief executive officer or any of the four other most highly compensated officers that exceeds for each officer \$1,000,000 during the tax year. Qualifying performance-based compensation paid pursuant to plans approved by shareholders is not subject to this deduction limitation. The committee attempts to preserve the federal tax deductibility of compensation to the extent reasonably practicable when doing so is consistent with the executive compensation objective and goals mentioned above. While the committee is aware of and understands the requirements of Section 162(m), it does not believe that compensation decisions should be based solely upon the amount of compensation that is deductible for federal income tax purposes. Accordingly, the committee reserves the right to approve elements of compensation for certain officers that are not fully deductible. For fiscal year 2006, the only officer who received compensation that was not fully deductible was Pier 1's chief executive officer.

The committee reviews and approves the level of base salary paid to the chief executive officer and the executive vice presidents. Base salary is based primarily upon Pier 1's competitiveness in the retail industry, Pier 1's profitability and the individual performance of the executive during that year. In determining Pier 1's competitiveness, the committee establishes a peer group of companies for comparative purposes. In determining an executive's compensation, the committee also considers other factors it believes are relevant to the determination, but it does not assign specific weights to the different factors. The committee believes that the base salaries paid to the chief executive officer and executive vice presidents during fiscal year 2006 were both fair and reasonable.

During the 2006 fiscal year, Pier 1 maintained an annual bonus plan for the chief executive officer and the executive vice presidents. Under that plan, bonus awards are paid if Pier 1 attains certain targeted levels of pretax income. The committee believes that pretax income is an important financial measurement when determining shareholder value. The committee periodically establishes percentages of target incentives to be paid when certain pretax income levels are met. Pretax income levels are established based on percentages of pretax profit during a period of not less than one fiscal quarter nor more than one fiscal year, as determined by the committee. Target incentives are expressed as a percentage of the base salary of participants and are competitive when compared to Pier 1's peer group.

The target bonus for the chief executive officer remained at 100% of his base salary for the fiscal year 2006 plan. The target bonuses for the executive vice presidents remained at 75% of base salaries for the period. Pier 1's committee believes that the targeted levels of pretax income and related target bonuses set for the chief executive officer and executive vice presidents during fiscal year 2006 were both fair and reasonable. The minimum level of pretax income, however, was not achieved in fiscal year 2006; therefore, the chief executive officer and executive vice presidents did not receive bonuses under the plan.

Pier 1 provides long-term incentives to executives and key employees through the grant of stock options and restricted stock awards. Under Pier 1's stock option plan, executives and other key employees may be awarded options to purchase Pier 1 stock at a purchase price equal to the fair market value of the stock on the date of grant. Awards under Pier 1's stock option plans are designed with the intention of both promoting Pier 1's success and retaining the executive or employee by giving value to the executive or employee only when there is a corresponding increase in value to all shareholders. Under Pier 1's restricted stock plan, executives may receive restricted stock awards, subject to a length of service restriction. Pier 1's restricted stock and stock option plans provide an effective retention tool while at the same time establish an incentive that links the interest of executives to that of all shareholders. The committee believes that the stock options and restricted stock awarded to Pier 1's chief executive officer and executive vice presidents during fiscal year 2006 were both fair and reasonable.

The committee also believes that the relative amounts of chief executive officer compensation and compensation paid to Pier 1's other executives demonstrates internal pay equity and is reasonable and consistent with external compensation differences in Pier 1's peer group and reference labor market.

In the future, the committee intends to use other incentives such as performance-based restricted stock in conjunction with stock option and time-based restricted stock awards as part of long-term compensation. The grants to executives and key employees are intended to reward them for Pier 1's performance and provide incentives for the executives and key employees to remain with Pier 1.

The compensation committee and the board of directors believe that attracting, retaining and motivating Pier 1's employees, and particularly Pier 1's senior management, are essential to Pier 1's performance. The committee will continue to administer and develop Pier 1's compensation programs in a manner designed to achieve these objectives.

#### **COMPENSATION COMMITTEE**

Tom M. Thomas, Chairman  
John H. Burgoyne  
Karen W. Katz

#### **COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION; CERTAIN RELATED PARTY TRANSACTIONS**

During the fiscal 2006 year, the compensation committee was composed of directors Thomas, Burgoyne and Katz, none of whom is an employee of Pier 1. No member of the committee served on the board of directors of any other company that either employs an executive who is a director of Pier 1 or includes on its board of directors another member of Pier 1's board.

Mr. Girouard's son, Mark Girouard, is employed by Pier 1 Services Company, a Pier 1 subsidiary. He is the Manager of Strategic Analysis in the finance department. In fiscal 2006, he was paid annual compensation less than \$100,000. Mark Girouard is not an officer of Pier 1 and did not report directly to Marvin Girouard.

Tom Thomas, a director of the company, is a shareholder of Winstead Sechrest & Minick P.C., a law firm that Pier 1 retained during the last fiscal year and proposes to retain during the current fiscal year. Mr. Thomas is not an executive officer of this law firm and beneficially owns substantially less than a 10% equity interest in this law firm. The fees paid by Pier 1 to this law firm during the law firm's last fiscal year were substantially less than 2% of the law firm's gross revenues.

On March 20, 2006, Pier 1 sold its subsidiary, The Pier Retail Group Limited, to Palli Limited for approximately \$15 million. Palli Limited is a wholly owned subsidiary of Lagerinn ehf, an Iceland corporation owned by Jakup a Dul Jacobsen. Collectively, as of that date, Lagerinn ehf, Mr. Jacobsen and Kaupthing Bank hf beneficially owned approximately 9.9% of Pier 1's common stock. This information regarding security ownership was obtained from a Schedule 13D filed with the Securities and Exchange Commission on February 6, 2006 by Jakup a Dul Jacobsen, Lagerinn ehf and Kaupthing Bank hf. Except for the ownership of Pier 1's common stock, Mr. Jacobsen, Lagerinn ehf and Kaupthing Bank are not otherwise affiliated with Pier 1.

#### **AUDIT COMMITTEE REPORT**

Each member of the audit committee is an independent director, as defined in the listing standards of the NYSE. In accordance with the committee's written charter, the committee assists the board in overseeing the quality and integrity of Pier 1's accounting, auditing and financial reporting practices. In performing its oversight function, the committee reviewed and discussed Pier 1's audited consolidated financial statements as of and for the fiscal year ended February 25, 2006 with management and Pier 1's independent auditors, including a discussion of the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments, and the clarity of disclosures in the financial statements. The committee also discussed with Pier 1's independent auditors all matters required by

generally accepted auditing standards, including those described in Statement on Auditing Standards No. 61, "Communication with Audit Committees" and, with and without management present, discussed and reviewed the results of the independent auditors' examination of the consolidated financial statements.

The committee obtained from the independent auditors a formal written statement describing all relationships between the auditors and Pier 1 that might affect the auditors' independence consistent with Independence Standards Board Standard No. 1, "Independence Discussions with Audit Committees." The committee also discussed with the auditors any relationships that may have an impact on their objectivity and independence and satisfied ourselves that the auditors are independent. The committee also considered whether the provision of non-audit services by Ernst & Young LLP, Pier 1's independent auditors for fiscal 2006, to Pier 1 is compatible with maintaining Ernst & Young LLP's independence.

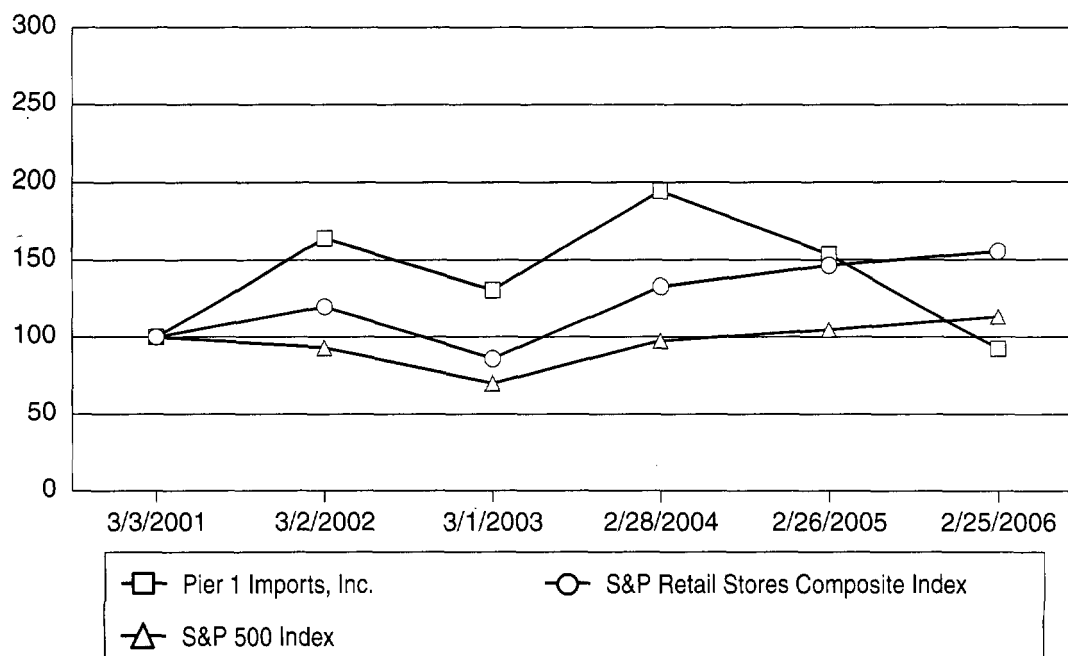
Based on the above-mentioned review and discussions with management and the independent auditors, the committee recommended to the board of directors that Pier 1's audited consolidated financial statements be included in Pier 1's Annual Report on Form 10-K for the fiscal year ended February 25, 2006, for filing with the SEC.

#### AUDIT COMMITTEE

James M. Hoak, Jr., Chairman  
Michael R. Ferrari  
Terry E. London

#### PIER 1 STOCK PERFORMANCE GRAPH

The following graph compares the five-year cumulative total shareholder return for Pier 1 common stock against the Standard & Poor's 500 Stock Index and the Dow Jones Industrial Average. The annual changes for the five-year period shown on the graph are based on the assumption, as required by SEC rules, that \$100 had been invested in Pier 1 stock and in each index on March 3, 2001 and that all quarterly dividends were reinvested at the average of the closing stock prices at the beginning and end of the quarter. The total cumulative dollar returns shown on the graph represent the value that such investments would have had on February 25, 2006.



## **PROPOSAL TO APPROVE THE PIER 1 IMPORTS, INC. 2006 STOCK INCENTIVE PLAN**

The board of directors on March 23, 2006 unanimously approved the adoption of the Pier 1 Imports, Inc. 2006 Stock Incentive Plan and unanimously recommends that the Pier 1 shareholders vote "FOR" approval of the adoption of the plan. If a proxy card is signed and returned but no direction is made, the proxy card will be voted "FOR" its adoption. The affirmative vote of holders of a majority of the shares of common stock present in person or represented by proxy and entitled to vote at the annual meeting is required to approve the proposed plan.

### **General**

The purpose of the plan is to promote the interests of Pier 1 and its shareholders by encouraging employees of Pier 1 and its non-employee directors to acquire or increase their equity interest in Pier 1, and to relate compensation to performance goals of Pier 1, thereby giving them an added incentive to work towards the continued growth and success of Pier 1. The board of directors also contemplates that through the plan, Pier 1 will be better able to compete for the services of personnel needed for growth and success. However, nothing in the plan will operate or be construed to prevent Pier 1 from granting awards outside of such plan. In the opinion of Pier 1, the plan is not subject to any of the provisions of the Employee Retirement Income Security Act of 1974.

The full text of the plan is set forth in Appendix A to this proxy statement. Certain features of the plan are summarized below, but this summary is qualified in its entirety by reference to the full text of the plan.

### **Types of Awards**

The plan permits the granting of the following types of awards to employees and directors: stock options to purchase shares of common stock, which may be either incentive stock options within the meaning of Section 422 of the Internal Revenue Code of 1986, or options that do not constitute incentive stock options; restricted stock awards; restricted stock unit awards; performance awards; and phantom stock awards, as summarized below. The plan also provides for granting deferred stock units to directors who are not employees of Pier 1.

### **Effective Date and Duration of the Plan**

The plan was adopted by the board of directors effective March 23, 2006, subject to approval by Pier 1's shareholders. No awards will be granted under the plan prior to approval of the plan by Pier 1's shareholders. Except with respect to awards then outstanding, if not sooner terminated, the plan will terminate on March 23, 2016, and no further awards may be granted after such date.

### **Administration**

The plan will be administered by a committee appointed by the board of directors, or any duly appointed subcommittee of such committee and shall be comprised solely of two or more outside directors within the meaning of the term "outside directors" as used in Section 162(m) of the Internal Revenue Code of 1986, and applicable interpretive authority thereunder and within the meaning of the term "Non-Employee Director" as defined in Rule 16b-3 of the Securities Exchange Act of 1934, as amended. Subject to the terms and conditions of the plan, the committee has authority to determine which employees or directors receive awards under the plan and when, to determine the type and terms of an award and to determine the number of shares to be issued pursuant to such awards (within the limits of the plan), to interpret the plan and all awards and to administer the plan. Such committee, in its sole discretion, may delegate any or all of its power and duties under the plan to the chief executive officer or to an officer or a group of officers of Pier 1, subject to such limitations on such delegated powers and duties as such committee may impose; provided, however, that the committee may not delegate its powers



if such delegation would result or potentially result in an award which is intended to qualify as performance-based compensation for purposes of Section 162(m) failing to so qualify.

### **Shares Subject to the Plan**

The aggregate number of shares of common stock that may be issued under the plan will not exceed 1,500,000 shares plus the number of shares (not to exceed 560,794) which remained available for grant under the Pier 1 1999 Stock Plan and the Pier 1 Management Restricted Stock Plan, increased by the number of shares (not to exceed 11,186,150) subject to outstanding awards under the Pier 1 1999 Stock Plan and the Pier 1 Management Restricted Stock Plan that cease for any reason to be subject to such awards, subject to adjustment in the event of stock splits and certain other corporate events. The aggregate maximum number of shares of common stock that may be issued under the plan through incentive stock options will not exceed 2,060,794 shares. The maximum number of shares of common stock that may be subject to awards denominated in shares of common stock granted to any one individual during any calendar year may not exceed 375,000 shares and the maximum amount of compensation that may be paid under all performance awards denominated in cash (including the fair market value of any shares paid in satisfaction of such performance awards) granted to any one individual during any calendar year may not exceed \$3 million. To the extent that an award lapses or the rights of its holder terminate, any shares subject to such award will again be available for the grant of an award under the plan. Such shares of common stock may be authorized but unissued shares or reacquired shares.

### **Eligibility for Participation**

Incentive stock options may be granted only to individuals who are employees (whether or not they are directors) of Pier 1 or any parent or subsidiary corporation (within the meaning of Section 424 of the Internal Revenue Code of 1986) of Pier 1 and directors deferred stock unit awards may only be granted to Pier 1 directors who are not employees of Pier 1. All other awards may be granted to either employees or non-employee directors of Pier 1.

### **Stock Options**

The committee has the authority to grant options that will be evidenced by an option agreement in such form as the committee may from time to time approve subject to the terms of the plan. The committee also has the authority to determine whether options granted to employees will be incentive stock options or nonqualified options. The committee may, with the consent of the person or persons entitled to exercise an option, amend an option, except that no such amendment shall reduce the exercise price of any option. The committee may at any time or from time to time, in its discretion, accelerate the time or times at which such option may be exercised to any earlier time or times.

The price at which shares of common stock may be purchased upon the exercise of an option shall be determined by the committee but such purchase price shall not be less than the fair market value per share of common stock at the time of the grant based on its closing price reported by the NYSE on the date such option is granted. The plan expressly prohibits the repricing of options without approval of the shareholders of Pier 1 except in the event of adjustments for stock splits and other corporate events.

No option may be exercised ten years after the date of the grant.

### **Restricted Stock and Restricted Stock Unit Awards**

The plan authorizes the committee to grant awards in the form of restricted shares of Pier 1 common stock and restricted stock units. Such awards shall be subject to an obligation to forfeit the units and forfeit and surrender the shares to Pier 1 based upon forfeiture restrictions. The forfeiture restrictions for an award will be determined by the committee, and the committee may provide that such restrictions lapse upon attainment of one or more performance measures, continued employment or service for a specified time, the occurrence of any event or the satisfaction of any other condition specified by the committee, or a combination of any of the foregoing. In no event will such restrictions lapse in full prior to a one-year

period following the grant in the case of restrictions that lapse upon the attainment of performance measures or a three-year period from the date of grant in the case of restrictions which lapse upon other than the attainment of performance measures. At the time an award is made, Pier 1 and the participant will enter into an agreement setting forth the matters contemplated by the plan and such other matters as the committee may determine to be appropriate.

### **Performance Awards**

The committee may grant performance awards that may be paid in shares of common stock, cash or a combination of both. All employees and directors are eligible to receive performance awards. The committee shall establish the number of shares subject to or the maximum cash value of the performance award, as applicable, and the performance period over which the performance applicable to the award shall be measured and the performance measures which constitute the business criteria on which the performance goal for a performance award is based. The performance measures established by the committee for a performance award shall be based upon (1) the fair market value of common stock, (2) Pier 1's earnings per share, (3) Pier 1's or an affiliate's market share, (4) the market share of a business unit of Pier 1 designated by the committee, (5) Pier 1's or an affiliate's sales, (6) the sales of a business unit of Pier 1 designated by the committee, (7) the net income (before or after taxes) of Pier 1, an affiliate or any business unit of Pier 1 designated by the committee, (8) the cash flow or return on investment of Pier 1, an affiliate or any business unit of Pier 1 designated by the committee, (9) the earnings before or after interest, taxes, depreciation, and/or amortization of Pier 1, an affiliate or any business unit of Pier 1 designated by the committee, (10) the economic value added, (11) the return on capital, assets or stockholders' equity achieved by Pier 1 or an affiliate, or (12) the total shareholders' return achieved by Pier 1. In the case of a performance award which is intended to be performance-based compensation for purposes of Section 162(m) of the Internal Revenue Code of 1986, the performance measures will be established either prior to the beginning of the award's performance period or within the first 90 days of such performance period provided that the outcome of the performance measures being established is then substantially uncertain. In no event shall a performance award vest prior to the expiration of a one-year period following the grant thereof. At the time an award is made, Pier 1 and the participant will enter into an agreement setting forth the matters contemplated by the plan and such other matters as the committee may determine to be appropriate.

### **Phantom Stock Awards**

The committee may grant phantom stock awards, which are rights to receive shares of common stock (or cash equal to the fair market value of a specified number of shares of common stock), or rights to receive an amount equal to any appreciation in the fair market value of common stock over a specified period of time, which vest over a period of time as established by the committee, without satisfaction of any performance criteria or objectives. A phantom stock award may include a stock appreciation right that is granted independently of an option or a stock appreciation right that is granted in tandem with an option. Any phantom stock award which is a stock appreciation right will have a maximum term of ten years and shall represent an award that measures appreciation only with reference to appreciation over the fair market value of the stock which is subject to the award as of the date of its grant. At the time an award is made, Pier 1 and the participant will enter into an agreement setting forth the matters contemplated by the plan and such other matters as the committee may determine to be appropriate.

### **Director Deferred Stock Unit Awards**

The plan provides for participation by non-employee directors in a deferred stock program. Each non-employee director (other than certain directors who made irrevocable elections in 1999 not to participate) must mandatorily defer 50% of all of their cash fees into a deferred stock account maintained by Pier 1. Such directors may elect to defer all or any portion of the remaining 50% of their cash fees provided that such deferral election for a taxable year is made prior to the beginning of such taxable year. All deferrals will be credited as deferred stock units. The number of deferred stock units issued is based on 150% of the

amount of cash fees deferred and the fair market value of Pier 1's common stock on the date of crediting the deferred fee. When a board member's position as a director terminates, the deferred stock units are exchanged into common stock and delivered to the departing director. Under the plan, deferred stock units are credited with dividends paid on Pier 1's common stock.

#### **Amendment and Termination of the Plan**

The board of directors may terminate the plan at any time with respect to any shares of common stock for which awards have not been granted. The board of directors shall have the right to alter or amend the plan or any part thereof from time to time; provided that no change in the plan may be made that would impair the rights of a participant with respect to an award previously granted without the consent of the participant, and provided, further, that the board of directors may not, without approval of the shareholders, increase the maximum aggregate number of shares that may be issued, increase the maximum number of shares that may be issued through incentive stock options, change the class of individuals eligible to receive awards, or amend or delete the provisions of the plan which contain restrictions on re-pricing of options.

### **FEDERAL INCOME TAX CONSEQUENCES OF THE PLAN**

#### **In General**

The plan is not qualified under Section 401(a) of the Internal Revenue Code of 1986, as amended.

The following summary is based on the applicable provisions of the Internal Revenue Code of 1986, as amended, as currently in effect and the income tax regulations and proposed income tax regulations thereunder.

#### **Status of Option**

Options granted under the plan may be either incentive stock options or nonqualified options. Under certain circumstances, an incentive stock option may be treated as a nonqualified option. The tax consequences both to the optionee and to Pier 1 differ depending on whether an option is an incentive stock option or a nonqualified option.

#### **Nonqualified Options**

No federal income tax is imposed on the optionee upon the grant of a nonqualified option. Upon exercise of a nonqualified option, the optionee will be treated as receiving compensation which is taxable as ordinary income in the year of exercise. The amount recognized as ordinary income upon such exercise is the excess of the fair market value of the shares of common stock at the time of exercise over the exercise price paid for such common stock. At the time common stock received upon exercise of a nonqualified option is disposed of, any difference between the fair market value of the shares of common stock at the time of exercise and the amount realized on the disposition would be treated as capital gain or loss. The gain, if any, realized upon such a disposition will be treated as long-term or short-term capital gain, depending on the holding period of the shares of common stock. Any loss realized upon such a disposition will be treated as a long-term or short-term capital loss, depending on the holding period of the shares of common stock.

Upon the optionee's exercise of a nonqualified option, and subject to the application of Section 162(m) of the Internal Revenue Code of 1986, as amended, as discussed below, Pier 1 may claim a deduction for the compensation paid at the same time and in the same amount as compensation is treated as being received by the optionee, assuming Pier 1 satisfies the federal income tax reporting requirements with respect to such compensation. Pier 1 is not entitled to any tax deduction in connection with a subsequent disposition by the optionee of the shares of common stock.

If the shares of common stock received upon the exercise of a nonqualified option are transferred to the optionee subject to certain restrictions, then the taxable income realized by the optionee, unless the optionee elects otherwise, and Pier 1's tax deduction (assuming federal income tax reporting requirements are satisfied) should be deferred and should be measured at the fair market value of the shares at the time the restrictions lapse. The insider trading restriction imposed on officers, directors and 10% shareholders by Section 16(b) of the Securities Exchange Act of 1934 is such a restriction during the period prescribed thereby if other shares have been purchased by such an individual within six months of the exercise of a nonqualified option.

### **Incentive Stock Options**

No federal income tax is imposed on the optionee upon the grant of an incentive stock option. The optionee would recognize no taxable income upon exercise of an incentive stock option if the optionee (a) does not dispose of the shares of common stock acquired pursuant to the exercise of an incentive stock option within two years from the date the option was granted or within one year after the shares of common stock were transferred to the optionee (the "Holding Period") and (b) is an employee of either (i) the company granting the option, (ii) a subsidiary of such corporation or (iii) a corporation which has assumed such option of another corporation as a result of a corporate reorganization, merger or similar transaction. Such employment must continue for the entire time from the date the option was granted until three months before the date of exercise, or 12 months before the date of exercise if employment ceases due to permanent and total disability. If common stock received upon exercise of an incentive stock option is disposed of after completion of the Holding Period, any difference between the exercise price paid for such common stock and the amount realized on the disposition would be treated as a capital gain or loss. The gain, if any, realized upon such a disposition will be treated as a long-term capital gain. Any loss realized upon such a disposition will be treated as a long-term capital loss. Pier 1 would not be entitled to any deduction in connection with the grant or exercise of the option or the disposition of the shares of common stock so acquired.

If, however, an optionee disposes of shares of common stock acquired pursuant to exercise of an incentive stock option before the Holding Period has expired (a "Disqualifying Disposition"), the optionee would be treated as having received, at the time of disposition, compensation taxable as ordinary income. In such event, subject to the application of Section 162(m) of the Internal Revenue Code of 1986, as amended, as discussed below, Pier 1 may claim a deduction for compensation paid at the same time and in the same amount as compensation is treated as being received by the optionee. The amount treated as compensation is the lesser of (i) the excess of the fair market value of the common stock at the time of exercise over the exercise price or (ii) the excess of the amount realized on disposition over the exercise price. The balance of the gain, if any, realized upon such a disposition will be treated as long-term or short-term capital gain depending on the holding period. If the amount realized at the time of the disposition is less than the exercise price, the optionee will not be required to treat any amount as ordinary income, provided that the disposition is of a type that would give rise to a recognizable loss. In such event, the loss will be treated as a long-term or short-term capital loss depending upon the holding period. A disposition generally includes a sale, exchange or gift, but does not include certain other transfers, such as by reason of death or a pledge or exchange of shares described in Section 424(c) of the Internal Revenue Code of 1986, as amended.

### **Restricted Stock and Restricted Stock Unit Awards**

An employee who has been granted restricted stock or restricted stock units will not realize taxable income at the time of grant, and Pier 1 will not be entitled to a deduction at that time, assuming that the forfeiture restrictions constitute a substantial risk of forfeiture for federal income tax purposes. Upon lapse of the forfeiture restrictions (i.e., as shares or units become vested), the employee will realize ordinary income in an amount equal to the fair market value of the shares or units at such time, and subject to Section 162(m) of the Internal Revenue Code, Pier 1 will be entitled to a corresponding deduction. Dividends on restricted stock paid to an employee during the forfeiture restriction period will also be

compensation income to the employee and deductible as such by Pier 1. An employee who has been awarded restricted stock may elect to be taxed at the time of grant of the restricted stock award on the market value of the shares subject to the award, in which case (i) subject to Section 162(m) of the Internal Revenue Code of 1986, as amended, as discussed below, Pier 1 will be entitled to a deduction at the same time and in the same amount, (ii) dividends paid to the employee during the forfeiture restriction period will be taxable as dividends to him and not deductible by Pier 1, and (iii) there will be no further federal income tax consequences when the forfeiture restrictions lapse. An employee who has been awarded restricted stock units may not elect to be taxed at the time of the grant of the restricted stock unit award.

### **Performance Awards**

An employee who has been granted a performance share award will not realize taxable income at the time of the grant and Pier 1 will not be entitled to a tax deduction at that time. The employee will realize ordinary income at the time the award is paid equal to the amount of cash paid or the value of shares delivered in payment of the award. At that time, Pier 1 will have a corresponding tax deduction which may or may not be subject to Section 162(m) of the Internal Revenue Code of 1986, as amended, as discussed below, depending upon whether the award was intended to qualify as and did, in fact, qualify as performance-based compensation for purposes of such Internal Revenue Code section.

### **Stock Appreciation Rights and Phantom Stock**

The amount received upon exercise of a stock appreciation right or upon receipt of cash or stock pursuant to an award of phantom stock is included in taxable income at the time the cash or stock is received. In the case of receipt of stock the amount included in income is fair market value of the stock received. Subject to Section 162(m) of the Internal Revenue Code of 1986, as amended, as discussed below, Pier 1 will be entitled to a deduction at the same time and in the same amount as the income recognized by the plan participant.

### **Director Deferred Stock Units**

The portion of a director's cash fee which is automatically and mandatorily deferred will not be includible in taxable income when earned and Pier 1 will not be entitled to a deduction with respect to the deferred director's fees at that time. Provided that a director's cash fee deferral election is made prior to the beginning of the taxable year in which the director's services for which the fees will be earned are performed and provided further that such deferral election is irrevocable, the director's fees deferred by a director on an elective basis will not be includible in taxable income when earned and Pier 1 will not be entitled to a deduction with respect to such fees at that time. The crediting of director deferred stock units with respect to deferred director's fees will not result in taxable income to the director when credited and Pier 1 will not be entitled to a deduction at that time. The crediting of dividend amounts as additional director deferred stock units will not result in taxable income to a director when credited and Pier 1 will not be entitled to a deduction at that time. At the time that deferred stock units are exchanged into shares which are delivered to a director, the director will recognize taxable income in an amount equal to the value of the shares delivered and Pier 1 will be entitled to a deduction at that time.

### **Withholding for Taxes**

No issuance of common stock under the plan may be made until arrangements satisfactory to Pier 1 have been made for the withholding of taxes. As to awards that are payable in shares of common stock, to the extent provided in the award agreement, a participant may direct Pier 1 to withhold a number of shares of common stock from such award having an aggregate fair market value equal to the amount of any tax required to be withheld with respect to such award.

## Additional Tax Consequences

Under Section 4999 of the Internal Revenue Code of 1986, as amended, golden parachute provisions may apply sanctions with respect to a participant who receives certain payments or benefits in the nature of compensation contingent on the change of ownership or effective control of Pier 1. These include imposition of a golden parachute penalty tax upon the recipient of such compensation and non-deductibility of such compensation by Pier 1, in each case to the extent that it constitutes an "excess" golden parachute payment. Certain of the actions which the plan empowers the committee to take with respect to awards upon the occurrence of a corporate change affecting Pier 1 (such as acceleration of vesting or effecting of payments, distributions or issuance of stock) may be subject to these golden parachute sanction provisions. The plan does not prohibit the committee from including in the agreement pursuant to which an award under the plan is granted a provision which obligates Pier 1 to pay a participant who may receive a benefit which is subject to the golden parachute penalty tax (generally, an officer or highly compensated employee) a gross-up payment from Pier 1 so that the amount of the "net" benefit received by such participant will equal the amount that would have been received in the absence of applicability of the golden parachute sanction penalty tax. Section 280G of the Internal Revenue Code of 1986, as amended, disallows a deduction to Pier 1 for amounts subject to the golden parachute penalty tax under Section 4999.

Section 162(m) of the Internal Revenue Code of 1986, as amended, places a \$1 million cap on the deductible compensation that may be paid to certain executives of publicly traded corporations. Amounts that qualify as "performance-based" compensation under Section 162(m)(4)(C) are exempt from the cap and do not count toward the \$1 million limit. Generally, options granted with an exercise price at least equal to the fair market value of the stock on the date of the grant will qualify as performance-based compensation. Other awards may or may not so qualify, depending on their terms.

## OTHER BUSINESS

Pier 1 does not plan to act on any matters at the meeting other than those described in this proxy statement. If any other business should properly come before the meeting, the persons named in the proxy will vote in accordance with their best judgment.

### Relationship with Independent Auditors

Pursuant to its charter, the audit committee is directly responsible for the appointment, compensation, retention and oversight of Pier 1's independent auditors. The audit committee plans to select auditors for the 2007 fiscal year at a committee meeting which will precede the annual meeting.

The audit committee appointed Ernst & Young LLP as Pier 1's auditors for fiscal year 2006. A representative of Ernst & Young LLP is expected to be present at the annual meeting and will be given the opportunity to make a statement if he or she so desires and to respond to appropriate questions from shareholders.

### Independent Auditor Fees

The following table presents fees incurred for professional services rendered by Ernst & Young LLP, Pier 1's independent auditors, for fiscal years ended February 25, 2006 and February 26, 2005.

	February 25, 2006	February 26, 2005
Audit Fees(1) .....	\$1,269,396	\$1,035,535
Audit-Related Fees(2) .....	51,227	54,100
Tax Fees(3) .....	229,468	187,000
Total Fees .....	<u>\$1,550,091</u>	<u>\$1,276,635</u>

- 
- (1) Includes fees for services related to the annual audit of the consolidated financial statements, required statutory audits, reviews of Pier 1's quarterly reports on Form 10-Q and the auditor's report on Pier 1's internal control over financial reporting, as required under Section 404 of the Sarbanes-Oxley Act of 2002.
  - (2) Includes fees for services related to employee benefit plan audit and agreed-upon procedures related to the securitization of Pier 1's proprietary credit card receivables.
  - (3) Includes fees for services related to tax compliance, tax advice and tax planning.

#### **Pre-approval of Nonaudit Fees**

The audit committee has adopted a policy that requires advance approval of all audit, audit-related, tax and other services performed by the independent auditor. The policy provides for pre-approval by the audit committee of specifically defined audit, audit related and tax services. Unless the specific service has been previously pre-approved with respect to that year, the audit committee must approve the permitted service before the independent auditor is engaged to perform it. The audit committee has delegated to the chairman of the audit committee authority to approve permitted services up to \$50,000 per engagement provided that the chairman reports any pre-approval decisions to the committee at its next scheduled meeting.

#### **Shareholder Proposals for 2007 Annual Meeting**

To be included in the proxy statement relating to the 2007 annual meeting of shareholders, shareholder proposals must be received by Pier 1's corporate secretary no later than 5:00 p.m., local time, January 15, 2007.

In order to bring a matter before the 2007 annual meeting of shareholders that is not contained in the proxy statement, including the nomination of an individual for election as a director, a shareholder must comply with the advance notice provisions of Pier 1's by-laws. Pier 1's by-laws require that it receive notice of the matter no earlier than March 24, 2007, and no later than April 23, 2007. You may contact Pier 1's corporate secretary to find out what specific information regarding the matter must be included with the advance notice.

#### **Proxy Solicitation**

Pier 1 has hired Mellon Investor Services, LLC to assist it in soliciting proxies. Pier 1 will pay all costs associated with the solicitation, including Mellon's fees, which it expects to be \$7,500 or less, and all mailing and delivery expenses. In addition to solicitations by mail, Pier 1's officers and employees may solicit proxies personally and by telephone or other means, for which they will receive no compensation beyond their normal compensation. Pier 1 may also make arrangements with brokerage houses and other custodians, nominees and fiduciaries to forward solicitation material to the beneficial owners of stock held of record by such persons, and it will reimburse them for their reasonable out-of-pocket and clerical expenses.

#### **Voting Securities**

Shareholders of record on April 24, 2006 will be entitled to vote at the meeting. On that date, 87,083,398 shares of Pier 1's common stock were outstanding and entitled to vote at the meeting. Each share of common stock entitles the holder to one vote on each matter voted on at the meeting. An abstention, if allowed for a proposal, will not be counted as voting for a matter, and, therefore, will have the same effect as a vote against the matter. Unless otherwise stated herein or on the proxy card, broker non-votes will not be counted as a vote either for or against the matter.

**Voting by Plan Administrator**

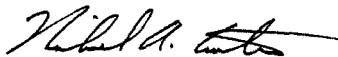
The enclosed proxy card also covers shares of Pier 1 common stock held for participants in Pier 1's Stock Purchase Plan and will serve as voting instructions for the plan administrator.

**Quorum**

Shareholders representing a majority of the shares of Pier 1's common stock outstanding as of April 24, 2006 must be present at the annual meeting in order to conduct business at the meeting.

**YOUR VOTE IS IMPORTANT**

You are encouraged to let us know your preference by completing and returning the enclosed proxy card or by voting by telephone or the Internet.



**Michael A. Carter**  
Senior Vice President and General Counsel,  
Corporate Secretary

May 15, 2006



## APPENDIX A

### PIER 1 IMPORTS, INC. 2006 STOCK INCENTIVE PLAN

#### I. PURPOSE OF THE PLAN

The purpose of the **PIER 1 IMPORTS, INC. 2006 STOCK INCENTIVE PLAN** (the "Plan") is to provide a means through which **PIER 1 IMPORTS, INC.**, a Delaware corporation (the "Company"), and its Affiliates may attract able persons to serve as Directors or to enter the employ of the Company and its Affiliates and to provide a means whereby those individuals upon whom the responsibilities of the successful administration and management of the Company and its Affiliates rest, and whose present and potential contributions to the Company and its Affiliates are of importance, can acquire and maintain stock ownership, thereby strengthening their concern for the welfare of the Company and its Affiliates. A further purpose of the Plan is to provide such individuals with additional incentive and reward opportunities designed to enhance the profitable growth of the Company and its Affiliates. Accordingly, the Plan provides for granting Incentive Stock Options, options that do not constitute Incentive Stock Options, Restricted Stock Awards, Restricted Stock Unit Awards, Performance Awards, and Phantom Stock Awards, or any combination of the foregoing, as is best suited to the circumstances of the particular employee or Director as provided herein. The Plan also provides for granting Director Deferred Stock Units to Directors who are not employees of the Company.

#### II. DEFINITIONS

The following definitions shall be applicable throughout the Plan unless specifically modified by any paragraph:

(a) "*Affiliate*" means any corporation, partnership, limited liability company or partnership, association, trust or other organization which, directly or indirectly, controls, is controlled by, or is under common control with, the Company. For purposes of the preceding sentence, "control" (including, with correlative meanings, the terms "controlled by" and "under common control with"), as used with respect to any entity or organization, shall mean the possession, directly or indirectly, of the power (i) to vote more than fifty percent (50%) of the securities having ordinary voting power for the election of directors of the controlled entity or organization, or (ii) to direct or cause the direction of the management and policies of the controlled entity or organization, whether through the ownership of voting securities or by contract or otherwise.

(b) "*Award*" means, individually or collectively, any Option, Restricted Stock Award, Restricted Stock Unit Award, Performance Award, Phantom Stock Award or Director Deferred Stock Unit Award.

(c) "*Board*" means the Board of Directors of the Company.

(d) "*Code*" means the Internal Revenue Code of 1986, as amended. Reference in the Plan to any section of the Code shall be deemed to include any amendments or successor provisions to such section and any regulations under such section.

(e) "*Committee*" means a committee of the Board that is selected by the Board as provided in Paragraph IV(a).

(f) "*Common Stock*" means the common stock, par value \$1.00 per share, of the Company or any security into which such common stock may be changed by reason of any transaction or event of the type described in Paragraph XII.

(g) "*Company*" means Pier 1 Imports, Inc., a Delaware corporation.

(h) "*Corporate Change*" shall mean any of the following events: (i) a merger or consolidation to which the Company is a party if the individuals and entities who were stockholders of the Company

immediately prior to the effective date of such merger or consolidation have beneficial ownership (as defined in Rule 13d-3 under the Exchange Act) of less than fifty percent (50%) of the total combined voting power for election of directors of the surviving corporation or other entity following the effective date of such merger or consolidation; (ii) the acquisition or holding of direct or indirect beneficial ownership (as defined in Rule 13d-3 under the Exchange Act) of securities of the Company representing in the aggregate thirty percent (30%) or more of the total combined voting power of the Company's then issued and outstanding voting securities by any person, entity or group of associated persons or entities acting in concert, other than any employee benefit plan of the Company or of any subsidiary of the Company or any entity holding such securities for or pursuant to the terms of any such plan; (iii) the election of members of the Board at a meeting of stockholders or by written consent, the majority of which were not nominated by the Board; (iv) the sale of all or substantially all of the assets of the Company to any person or entity that is not a wholly owned subsidiary of the Company; or (v) the approval by the stockholders of the Company of any plan or proposal for the liquidation of the Company or of its subsidiaries (other than into the Company).

(i) "*Director*" means an individual who is a member of the Board.

(j) "*Director Compensation Payment*" means a payment to a Director of a Director's retainer fee or a Director's meeting fee.

(k) "*Director Deferred Stock Unit Award*" means an Award of deferred stock units granted under Paragraph XI of the Plan.

(l) "*Effective Date*" means the date of the Plan's adoption by the Board.

(m) An "*employee*" means any person (including a Director) in an employment relationship with the Company or any Affiliate.

(n) "*Exchange Act*" means the Securities Exchange Act of 1934, as amended.

(o) "*Fair Market Value*" means, as of any specified date, the fair market value of the Common Stock as determined by the Committee based upon its closing sale price reported by the New York Stock Exchange on that date.

(p) "*Incentive Stock Option*" means an incentive stock option within the meaning of section 422 of the Code.

(q) "*Option*" means an Award granted under Paragraph VII of the Plan and includes both Incentive Stock Options to purchase Common Stock and options that do not constitute Incentive Stock Options to purchase Common Stock.

(r) "*Option Agreement*" means a written agreement between the Company and a Participant with respect to an Option.

(s) "*Participant*" means an employee or Director who has been granted an award.

(t) "*Performance Award*" means an Award granted under Paragraph IX of the Plan.

(u) "*Performance Award Agreement*" means a written agreement between the Company and a Participant with respect to a Performance Award.

(v) "*Performance Measures*" means performance measures established by the Committee that are based on (1) the Fair Market Value of Common Stock, (2) the Company's earnings per share, (3) the Company's or an Affiliate's market share, (4) the market share of a business unit of the Company designated by the Committee, (5) the Company's or an Affiliate's sales, (6) the sales of a business unit of the Company designated by the Committee, (7) the net income (before or after taxes) of the Company, an Affiliate or any business unit of the Company designated by the Committee, (8) the cash flow or return on investment of the Company, an Affiliate or any business unit of the Company designated by the Committee, (9) the earnings before or after interest, taxes, depreciation, and/or amortization of the Company, an Affiliate or any business unit of the Company

designated by the Committee, (10) the economic value added, (11) the return on capital, assets or stockholders' equity achieved by the Company or an Affiliate, or (12) the total stockholders' return achieved by the Company. Performance Measures established for an Award may thereafter be subject to adjustment for specified significant extraordinary items or events, including but not limited to (1) asset write-downs; (2) litigation or claim judgments or settlements; (3) the effect of changes in tax laws, accounting principles or other laws or provisions affecting reported results; (4) any reorganization and restructuring programs; (5) extraordinary nonrecurring items as described in Accounting Principles Board Opinion No. 30 and/or in management's discussion and analysis of financial condition and results of operations appearing in the Company's annual report to shareholders for the applicable year; (6) acquisitions or divestitures; and (7) foreign exchange gains and losses. To the extent any such adjustment is to be effected with respect to an Award, it shall be prescribed in a form that meets the requirements of section 162(m) of the Code for deductibility if the Committee, in its sole discretion, determines that loss of deductibility is a significant exposure for the Company. The Performance Measures may be absolute, relative to one or more other companies, or relative to one or more indexes, and may be contingent upon future performance of the Company or any Affiliate, division, or department thereof.

(w) "*Phantom Stock Award*" means an Award granted under Paragraph X of the Plan.

(x) "*Phantom Stock Award Agreement*" means a written agreement between the Company and a Participant with respect to a Phantom Stock Award.

(y) "*Plan*" means the Pier 1 Imports, Inc. 2006 Stock Incentive Plan, as amended from time to time.

(z) "*Prior Plans*" means the Pier 1 Imports, Inc. 1999 Stock Plan and the Pier 1 Imports, Inc. Management Restricted Stock Plan.

(aa) "*Restricted Stock Award*" means an Award of restricted stock granted under Paragraph VIII of the Plan.

(bb) "*Restricted Stock Award Agreement*" means a written agreement between the Company and a Participant with respect to a Restricted Stock Award.

(cc) "*Restricted Stock Unit Award*" means an Award of restricted stock units granted under Paragraph VIII of the Plan.

(dd) "*Restricted Stock Unit Award Agreement*" means a written agreement between the Company and a Participant with respect to a Restricted Stock Unit Award.

(ee) "*Rule 16b-3*" means SEC Rule 16b-3 promulgated under the Exchange Act, as such may be amended from time to time, and any successor rule, regulation or statute fulfilling the same or a similar function.

(ff) "*Stock Appreciation Right*" means a right to acquire, upon exercise of the right, Common Stock and/or, in the sole discretion of the Committee, cash having an aggregate value equal to the then excess of the Fair Market Value of the shares with respect to which the right is exercised over the exercise price therefor.

### **III. EFFECTIVE DATE AND DURATION OF THE PLAN**

The Plan shall become effective upon the date of its adoption by the Board, provided the Plan is approved by the stockholders of the Company within twelve (12) months thereafter. Notwithstanding any provision in the Plan, no Option shall be granted, no Restricted Stock Award shall be granted, no Restricted Stock Unit Award shall be granted, no Director Deferred Stock Unit Award shall be granted and no Performance Award or Phantom Stock Award shall be granted prior to such stockholder approval. No further Awards may be granted under the Plan after ten (10) years from the date the Plan is adopted by the Board. The Plan shall remain in effect until all Options granted under the Plan have been exercised

or expired, all Restricted Stock Awards and all Restricted Stock Unit Awards granted under the Plan have vested or been forfeited, all Performance Awards and Phantom Stock Awards have been satisfied, expired, or forfeited and all Director Deferred Stock Unit Awards have been satisfied.

#### IV. ADMINISTRATION

(a) *Composition of Committee.* The Plan shall be administered by a committee of, and appointed by, the Board or any duly appointed subcommittee of the Committee, that shall be comprised solely of two (2) or more outside Directors (within the meaning of the term "outside directors" as used in section 162(m) of the Code and applicable interpretive authority thereunder and within the meaning of the term "Non-Employee Director" as defined in Rule 16b-3).

(b) *Powers.* Subject to the express provisions of the Plan, the Committee shall have authority, in its discretion, to determine which employees or Directors shall receive an Award, the time or times when such Award shall be made, the type of Award that shall be made, the number of shares to be subject to each Option, Restricted Stock Award or Restricted Stock Unit Award, the number of shares subject to or the value of each Performance Award, and the value of each Phantom Stock Award. In making such determinations, the Committee shall take into account the nature of the services rendered by the respective employees or Directors, their present and potential contribution to the Company's success and such other factors as the Committee in its sole discretion shall deem relevant.

(c) *Additional Powers.* The Committee shall have such additional powers as are delegated to it by the other provisions of the Plan. Subject to the express provisions of the Plan, this shall include the power to construe the Plan and the respective agreements executed hereunder, to prescribe rules and regulations relating to the Plan, and to determine the terms, restrictions and provisions of the agreement relating to each Award, including such terms, restrictions and provisions as shall be requisite in the judgment of the Committee to cause designated Options to qualify as Incentive Stock Options, and to make all other determinations necessary or advisable for administering the Plan. The Committee may correct any defect or supply any omission or reconcile any inconsistency in the Plan or in any agreement relating to an Award in the manner and to the extent it shall deem expedient to carry it into effect. The determinations of the Committee on the matters referred to in this Paragraph IV shall be conclusive.

(d) *Delegation of Powers.* The Committee may from time to time and in its sole discretion delegate any and all of its powers to the Chief Executive Officer of the Company or to an officer or a group of officers of the Company; provided, however, that the Committee shall not delegate any powers or responsibilities if such delegation would result or potentially result in an Award which is intended to qualify as performance-based compensation for purposes of section 162(m) of the Code failing to qualify as such performance-based compensation. The powers of delegation pursuant to this paragraph include but are not limited to the Committee's powers to administer the Plan, to interpret provisions of the Plan and to grant Awards under the Plan, insofar as such administration, interpretation and power to grant Awards relates to any person who is not subject to Section 16 of the Exchange Act (including any successor section to the same or similar effect). The Committee may revoke any delegation of its powers at any time and may put any conditions or restrictions on any powers which it has delegated as it determines in its sole discretion. In the event of any conflict in a determination or interpretation under the Plan as between the Committee and a person or group of persons to whom powers of determination or interpretation have been delegated by the Committee, the determination or interpretation, as applicable, of the Committee shall be conclusive.

#### V. SHARES SUBJECT TO THE PLAN; AWARD LIMITS; GRANT OF AWARDS

(a) *Shares Subject to the Plan and Award Limits.* Subject to adjustment in the same manner as provided in Paragraph XII(b), the aggregate number of shares of Common Stock that may be issued under the Plan shall not exceed (i) 1,500,000 shares plus (ii) the number of shares of Common Stock (not to exceed 560,794) which remained available for grant under the Prior Plans as of the Effective Date

increased by the number of shares of Common Stock (not to exceed 11,186,150 shares) subject to outstanding awards, as of the Effective Date, under the Prior Plans that on or after the Effective Date cease for any reason to be subject to such awards (other than by reason of exercise or settlement of the awards to the extent they are exercised for or settled in vested and nonforfeitable shares of Common Stock). The aggregate maximum number of shares of Common Stock that may be issued under the Plan through Incentive Stock Options shall not exceed 2,060,794 shares. Shares shall be deemed to have been issued under the Plan only to the extent actually granted pursuant to an Award; provided, however, that the Committee shall not grant any Award which potentially will result in the issuance of shares of Common Stock if such issuance would cause the Plan to exceed the limits described in the preceding two sentences if all Options then outstanding were exercised in full by participants. To the extent that an Award lapses or the rights of its holder terminate, any shares of Common Stock subject to such Award shall again be available for the grant of an Award under the Plan. In addition, shares issued under the Plan and forfeited back to the Plan, shares surrendered in payment of the exercise price or purchase price of an Award, and shares withheld for payment of applicable employment taxes and/or withholding obligations associated with an Award shall again be available for the grant of an Award under the Plan. Notwithstanding any provision in the Plan to the contrary, the maximum number of shares of Common Stock that may be subject to Awards denominated in shares of Common Stock granted to any one individual during any calendar year may not exceed 375,000 shares of Common Stock (subject to adjustment in the same manner as provided in Paragraph XII(b)) and the maximum amount of compensation that may be paid under all Performance Awards denominated in cash (including the Fair Market Value of any shares of Common Stock paid in satisfaction of such Performance Awards) granted to any one individual during any calendar year may not exceed \$3 million. The limitations set forth in the preceding sentence shall be applied in a manner that will permit awards that are intended to provide "performance-based" compensation for purposes of section 162(m) of the Code to satisfy the requirements of such section, including, without limitation, counting against such maximum number of shares, to the extent required under section 162(m) of the Code and applicable interpretive authority thereunder, any shares subject to Options that are canceled or repriced.

(b) Grant of Awards. The Committee may from time to time grant Awards to one or more employees or Directors determined by it to be eligible for participation in the Plan in accordance with the terms of the Plan.

(c) Stock Offered. Subject to the limitations set forth in Paragraph V(a), the stock to be offered pursuant to the grant of an Award may be authorized but unissued Common Stock or Common Stock previously issued and outstanding and reacquired by the Company. Any of such shares which remain unissued and which are not subject to outstanding Awards at the termination of the Plan shall cease to be subject to the Plan but, until termination of the Plan, the Company shall at all times make available a sufficient number of shares to meet the requirements of the Plan.

## VI. ELIGIBILITY

Awards may be granted only to persons who, at the time of grant, are employees or Directors. An Award may be granted on more than one occasion to the same person, and, subject to the limitations and restrictions set forth in the Plan, such Award may include an Incentive Stock Option, an Option that is not an Incentive Stock Option, a Restricted Stock Award, a Restricted Stock Unit Award, a Performance Award, a Phantom Stock Award, a Director Deferred Stock Unit Award or any combination thereof.

## VII. STOCK OPTIONS

(a) Option Period. The term of each Option shall be as specified by the Committee at the date of grant, but in no event shall an Option be exercisable after the expiration of ten (10) years from the date of grant.

(b) Limitations on Exercise of Option. An Option shall be exercisable in whole or in such installments and at such times as determined by the Committee.

(c) Special Limitations on Incentive Stock Options. An Incentive Stock Option may be granted only to an individual who is employed by the Company or any parent or subsidiary corporation (as defined in section 424 of the Code) at the time the Option is granted. To the extent that the aggregate Fair Market Value (determined at the time the respective Incentive Stock Option is granted) of stock with respect to which Incentive Stock Options are exercisable for the first time by an individual during any calendar year under all incentive stock option plans of the Company and its parent and subsidiary corporations exceeds \$100,000, such Incentive Stock Options shall be treated as Options which do not constitute Incentive Stock Options. The Committee shall determine, in accordance with applicable provisions of the Code, Treasury Regulations and other administrative pronouncements, which of a Participant's Incentive Stock Options will not constitute Incentive Stock Options because of such limitation and shall notify the Participant of such determination as soon as practicable after such determination. No Incentive Stock Option shall be granted to an individual if, at the time the Option is granted, such individual owns stock possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Company or of its parent or subsidiary corporation, within the meaning of section 422(b)(6) of the Code, unless (i) at the time such Option is granted the option price is at least one hundred ten percent (110%) of the Fair Market Value of the Common Stock subject to the Option and (ii) such Option by its terms is not exercisable after the expiration of five years from the date of grant. Except as otherwise provided in sections 421 or 422 of the Code, an Incentive Stock Option shall not be transferable otherwise than by will or the laws of descent and distribution, and shall be exercisable during the Participant's lifetime only by such Participant or the Participant's guardian or legal representative.

(d) Option Agreement. Each Option shall be evidenced by an Option Agreement in such form and containing such provisions not inconsistent with the provisions of the Plan as the Committee from time to time shall approve, including, without limitation, provisions to qualify an Option as an Incentive Stock Option under section 422 of the Code. Each Option Agreement shall specify the effect of termination of employment or service as a Director (by retirement, disability, death or otherwise), as applicable, on the exercisability of the Option. An Option Agreement may provide for the payment of the option price, in whole or in part, by the delivery of a number of shares of Common Stock (plus cash if necessary) having a Fair Market Value equal to such option price. Moreover, an Option Agreement may provide for a "cashless exercise" or "net share exercise" of the Option by establishing procedures satisfactory to the Committee with respect thereto. The terms and conditions of the respective Option Agreements need not be identical. Subject to the consent of the Participant, the Committee may, in its sole discretion, amend an outstanding Option Agreement from time to time in any manner that is not inconsistent with the provisions of the Plan (including, without limitation, an amendment that accelerates the time at which the Option, or a portion thereof, may be exercisable).

(e) Option Price and Payment. The price at which a share of Common Stock may be purchased upon exercise of an Option shall be determined by the Committee but, subject to adjustment as provided in Paragraph XII(b), such purchase price shall not be less than the Fair Market Value of a share of Common Stock on the date such Option is granted. The Option or portion thereof may be exercised by delivery of an irrevocable notice of exercise to the Company, as specified by the Committee. The purchase price of the Option or portion thereof shall be paid in full in the manner prescribed by the Committee. Separate stock certificates shall be issued by the Company for those shares acquired pursuant to the exercise of an Incentive Stock Option and for those shares acquired pursuant to the exercise of any Option that does not constitute an Incentive Stock Option.

(f) Restrictions on Repricing of Options. Except as provided in Paragraph XII, the Committee may not, without approval of the stockholders of the Company, amend any outstanding Option Agreement to lower the option price (or cancel and replace any outstanding Option Agreement with Option Agreements having a lower option price).

(g) Stockholder Rights and Privileges. The Participant shall be entitled to all the privileges and rights of a stockholder only with respect to such shares of Common Stock as have been purchased upon exercise of the Option and for which certificates of stock have been registered in the Participant's name.

(h) Options and Rights in Substitution for Options Granted by Other Employers. Options and Stock Appreciation Rights may be granted under the Plan from time to time in substitution for options and such rights held by individuals providing services to corporations or other entities who become employees or Directors as a result of a merger or consolidation or other business transaction with the Company or any Affiliate.

## **VIII. RESTRICTED STOCK AND RESTRICTED STOCK UNIT AWARDS**

(a) Forfeiture Restrictions To Be Established by the Committee. Restricted Stock Unit Awards and shares of Common Stock that are the subject of a Restricted Stock Award shall be subject to restrictions on disposition by the Participant and an obligation of the Participant to forfeit the units or forfeit and surrender the shares to the Company under certain circumstances (the "Forfeiture Restrictions"). The Forfeiture Restrictions shall be determined by the Committee in its sole discretion, and the Committee may provide that the Forfeiture Restrictions applicable to an Award shall lapse upon (i) the attainment of one or more Performance Measures, (ii) the Participant's continued employment with the Company or continued service as a Director for a specified period of time, (iii) the occurrence of any event or the satisfaction of any other condition specified by the Committee in its sole discretion, or (iv) a combination of any of the foregoing. Each Restricted Stock Award and each Restricted Stock Unit Award may have different Forfeiture Restrictions, in the discretion of the Committee. In no event shall the Forfeiture Restrictions with respect to a Restricted Stock Award or a Restricted Stock Unit Award lapse in full prior to the expiration of (i) a one-year period following the grant of the Award in the case of Forfeiture Restrictions that lapse upon the attainment of one or more Performance Measures or (ii) a three-year period from the date of grant of the Award in the case of Forfeiture Restrictions which lapse upon other than the attainment of one or more Performance Measures. In the case of a Restricted Stock Award or Restricted Stock Unit Award under which the Forfeiture Restrictions lapse upon the attainment of one or more Performance Measures, the Committee shall establish the Performance Measures applicable to such Award either (i) prior to the beginning of the performance period or (ii) within ninety (90) days after the beginning of the Awards performance period if the outcome of the performance targets is substantially uncertain at the time such targets are established, but not later than the date that twenty-five percent (25%) of the Awards performance period has elapsed.

(b) Restricted Stock Award Terms and Conditions. Common Stock awarded pursuant to a Restricted Stock Award shall be represented by a stock certificate registered in the name of the Participant or designated for such Participant on the records of the transfer agent for Common Stock. Each stock certificate issued with respect to a Restricted Stock Award shall bear the following or a similar legend: "The transferability of this certificate and the shares of Common Stock represented hereby are subject to the terms, conditions and restrictions (including forfeiture) contained in the Pier 1 Imports, Inc. 2006 Stock Incentive Plan and the Restricted Stock Award Agreement entered into between the registered owner and Pier 1 Imports, Inc. A copy of such plan and agreement is on file in the office of Pier 1 Imports, Inc., 100 Pier 1 Place, Fort Worth, Texas 76102." Unless provided otherwise in a Restricted Stock Award Agreement, the Participant shall have the right to receive dividends with respect to Common Stock subject to a Restricted Stock Award, to vote Common Stock subject thereto and to enjoy all other stockholder rights, except that (i) the Participant shall not be entitled to delivery of the stock certificate until the Forfeiture Restrictions have expired, (ii) the Company shall retain custody of the stock until the Forfeiture Restrictions have expired, (iii) the Participant may not sell, transfer, pledge, exchange, hypothecate or otherwise dispose of the stock until the Forfeiture Restrictions have expired, (iv) a breach of the terms and conditions established by the Committee pursuant to the Restricted Stock Award Agreement shall cause a forfeiture of the Restricted Stock Award, and (v) with respect to the payment of any dividend with respect to shares of Common Stock subject to a Restricted Stock Award directly to the Participant, each such dividend shall be paid at the same time as are paid dividends to stockholders of

such class of shares. At the time of such Award, the Committee may, in its sole discretion, prescribe additional terms, conditions or restrictions relating to Restricted Stock Awards, including, but not limited to, rules pertaining to the termination of employment or service as a Director (by retirement, disability, death or otherwise) of a Participant prior to expiration of the Forfeitures Restrictions. Such additional terms, conditions or restrictions shall be set forth in a Restricted Stock Award Agreement made in conjunction with the Award.

(c) Payment for Restricted Stock. The Committee shall determine the amount and form of any payment for Common Stock received pursuant to a Restricted Stock Award, provided that in the absence of such a determination, a Participant shall not be required to make any payment for Common Stock received pursuant to a Restricted Stock Award, except to the extent otherwise required by law.

(d) Restricted Stock Unit Award Terms and Conditions. A Restricted Stock Unit Award is a right to receive cash or shares of Common Stock based upon a bookkeeping entry referencing a value expressed by reference to shares of Common Stock and subject to forfeiture pursuant to Forfeiture Restrictions. A Participant shall have no right to receive dividends or any other right and privilege of a shareholder with respect to Common Stock which is the measure of a Restricted Stock Unit Award. At the time of grant of a Restricted Stock Unit Award, the Committee may, in its sole discretion prescribe additional terms, conditions or restrictions relating to the Awards, including, but not limited to, rules pertaining to the termination of employment or service as a Director (by retirement, disability, death or otherwise) of a Participant prior to expiration of the Forfeitures Restrictions. Such additional terms, conditions or restrictions shall be set forth in a Restricted Stock Unit Award Agreement made in conjunction with the Award.

(e) Committee's Discretion to Accelerate Vesting of Restricted Stock Awards and Restricted Stock Unit Awards. Except as it would cause Plan failure under Section 409A of the Code, the Committee may, in its discretion and as of a date determined by the Committee, fully vest any or all Common Stock awarded to a Participant pursuant to a Restricted Stock Award or any or all Restricted Stock Unit Awards of a Participant which are then still subject to Forfeiture Restrictions and, upon such vesting, all Forfeiture Restrictions applicable to such Restricted Stock Award or Restricted Stock Unit Awards shall terminate as of such date. Any action by the Committee pursuant to this subparagraph may vary among individual Participants and may vary among the Restricted Stock Awards or Restricted Stock Unit Awards held by any individual Participant. Notwithstanding the preceding provisions of this subparagraph and except as permitted pursuant to paragraph (c) of Section XII regarding a Corporate Change, the Committee may not take any action described in this subparagraph with respect to a Restricted Stock Award or a Restricted Stock Unit Award that has been granted to a "covered employee" (within the meaning of Treasury Regulation section 1.162-27(c)(2)) if such Award has been designed to meet the exception for performance-based compensation under section 162(m) of the Code or with respect to a Restricted Stock Unit Award that would result in adverse tax consequence of the Award holder under Section 409A of the Code.

(f) Restricted Stock Award Agreements and Restricted Stock Unit Award Agreements. At the time any Award is made under this Paragraph VIII, the Company and the Participant shall enter into a Restricted Stock Award Agreement or Restricted Stock Unit Award Agreement, as applicable, setting forth each of the matters contemplated hereby and such other matters as the Committee may determine to be appropriate. The terms and provisions of the respective Restricted Stock Award Agreements or Restricted Stock Unit Award Agreements, as applicable, need not be identical. Subject to the consent of the Participant and the restriction set forth in the last sentence of subparagraph (e) above, the Committee may, in its sole discretion, amend an outstanding Restricted Stock Award Agreement from time to time in any manner that is not inconsistent with the provisions of the Plan.

## IX. PERFORMANCE AWARDS

(a) Performance Period. The Committee shall establish, with respect to and at the time of each Performance Award, whether the Award is to be an Award of shares of Common Stock or a cash Award,



the number of shares of Common Stock subject to or the maximum cash value of the Performance Award, as applicable, and the performance period over which the performance applicable to the Performance Award shall be measured.

(b) Performance Measures. A Performance Award shall be awarded to a Participant contingent upon future performance of the Company or any Affiliate, division, or department thereof during the performance period. The Committee shall establish the Performance Measures applicable to a Performance Award either (i) prior to the beginning of the performance period or (ii) within ninety (90) days after the beginning of the performance period if the outcome of the performance targets is substantially uncertain at the time such targets are established, but not later than the date that twenty-five percent (25%) of the performance period has elapsed. The Committee, in its sole discretion, may provide for an adjustable Performance Award value based upon the level of achievement of Performance Measures and/or provides for a reduction in the value of a Performance Award during the performance period. In no event shall a Performance Award vest in full prior to the expiration of a one-year period following the grant of the Award.

(c) Awards Criteria. In determining the value of Performance Awards, the Committee shall take into account a Participant's responsibility level, performance, potential, other Awards, and such other considerations as it deems appropriate. The Committee, in its sole discretion, may provide for a reduction in the value of a Participant's Performance Award during the performance period.

(d) Payment. Following the end of the performance period for a Performance Award and in no event later than ten (10) years after the date of grant of such Performance Award, the holder of the Performance Award shall be entitled to receive payment of an amount not exceeding the number of shares of Common Stock subject to or the maximum cash value of the Performance Award, as applicable, based on the achievement of the performance measures for such performance period, as determined and certified in writing by the Committee. Payment of a Performance Award for a performance period shall be in full immediately following the end of such performance period but in no event later than the fifteenth day of the third calendar month after the later of the calendar year immediately following the calendar year with which or with in which the performance period ends or the taxable year of the Company immediately following the taxable year at the Company with which or within which the performance period ends and may be made in cash, Common Stock, or a combination thereof, as determined by the Committee. If a Performance Award covering shares of Common Stock is to be paid in cash, such payment shall be based on the Fair Market Value of the Common Stock on the payment date or such other date as may be specified by the Committee in the Performance Award Agreement. If a cash Performance Award is to be paid in shares of Common Stock, the number of shares of such payment shall be determined based upon the Fair Market Value of the Common Stock on the date of payment or such other date as may be specified by the Committee in the Performance Award Agreement.

(e) Termination of Award. A Performance Award shall terminate if the Participant does not remain continuously in the employ of the Company and its Affiliates or does not continue to serve as a Director for the Company at all times during the applicable performance period, except as may be determined by the Committee.

(f) Performance Award Agreements. At the time any Award is made under this Paragraph IX, the Company and the Participant shall enter into a Performance Award Agreement setting forth each of the matters contemplated hereby, and such additional matters as the Committee may determine to be appropriate. The terms and provisions of the respective Performance Award Agreements need not be identical.

## **X. PHANTOM STOCK AWARDS**

(a) Phantom Stock Awards. Phantom Stock Awards are rights to receive shares of Common Stock (or the Fair Market Value thereof), or rights to receive an amount equal to any appreciation or increase in the Fair Market Value of Common Stock over a specified period of time, which vest over a period of time

as established by the Committee, without satisfaction of any performance criteria or objectives. The Committee may, in its discretion, require payment or other conditions of the Participant respecting any Phantom Stock Award. A Phantom Stock Award may include, without limitation, a Stock Appreciation Right that is granted independently of an Option or a Stock Appreciation Right that is granted in tandem with an Option. Any Phantom Stock Award which is a Stock Appreciation Right shall have a maximum term of ten years and shall represent an Award that measures appreciation or increase in the Fair Market Value of Common Stock only with reference to appreciation over the Fair Market Value of the Common Stock which is the subject of the Award as of the date of grant thereof.

(b) Award Period. The Committee shall establish, with respect to and at the time of each Phantom Stock Award, a period over which the Award shall vest with respect to the Participant; provided, however, no Phantom Stock Award will vest in full prior to the expiration of a three year period from the date of its grant.

(c) Awards Criteria. In determining the value of Phantom Stock Awards, the Committee shall take into account a Participant's responsibility level, performance, potential, other Awards, and such other considerations as it deems appropriate.

(d) Payment. Following the end of the vesting period for a Phantom Stock Award (or at such other time as the applicable Phantom Stock Award Agreement may provide) or upon an exercise by a Participant of a payment right and in no event later than ten (10) years after the date of grant of such Phantom Stock Award, the holder of the Phantom Stock Award shall be entitled to receive payment of an amount, not exceeding the maximum value of the Phantom Stock Award, based on the then vested or exercised value of the Award. Payment of a Phantom Stock Award may be made in cash, Common Stock, or a combination thereof as determined by the Committee. Payment shall be made in a lump sum as soon as practicable following vesting or exercise of the Award but in no event later than the fifteenth day of the third calendar month after the later of the calendar year immediately following the calendar year in which such vesting occurred or the taxable year of the Company immediately following the taxable year of the Company with which or within such vesting occurred. Any payment to be made in cash shall be based on the Fair Market Value of the Common Stock on the payment date or such other date as may be specified by the Committee in the Phantom Stock Award Agreement.

(e) Termination of Award. A Phantom Stock Award shall terminate if the Participant does not remain continuously in the employ of the Company and its Affiliates or does not continue to serve as a Director for the Company at all times during the applicable vesting period, except as may be otherwise determined by the Committee.

(f) Phantom Stock Award Agreements. At the time any Award is made under this Paragraph X, the Company and the Participant shall enter into a Phantom Stock Award Agreement setting forth each of the matters contemplated hereby, and such additional matters as the Committee may determine to be appropriate. The terms and provisions of the respective Phantom Stock Award Agreements need not be identical.

## **XI. DIRECTOR DEFERRED STOCK UNIT AWARDS**

(a) Director Deferred Stock. A Director Deferred Stock Unit Award provides deferral of part or all of a Director's Director Compensation Payment into deferred stock units. Director Deferred Stock Unit Awards shall only be available to Directors who are not employees. A Director Deferred Stock Unit Award is a right to receive shares of Common Stock based upon a bookkeeping entry referencing a value expressed by reference to shares of Common Stock. Each Director who is not an employee (other than certain Directors who made irrevocable elections in 1999 not to participate under the Pier 1 Imports, Inc. Deferred Stock Program) shall, in lieu of being paid fifty percent (50%) of a Director Compensation Payment in cash, be awarded deferred stock units in an amount equal to 1.5 times the dollar amount of such Director Compensation Payment divided by the Fair Market Value of a share of Common Stock determined as of the date that such deferred Director Compensation Payment amount would otherwise

have been paid to the Director in cash. Any Director who is receiving automatic Director Deferred Stock Unit Awards may elect by executing and filing with the Committee the form prescribed by the Committee for such election to have all or any portion of the remaining fifty percent (50%) of such Director's Director Compensation Payment credited to such Director in the form of deferred stock units in lieu of being paid to such Director in cash in an amount determined by dividing 1.5 times the amount of cash that would otherwise have been payable with respect to a Director Compensation Payment by the Fair Market Value of a share of Common Stock determined as of the date that such deferred Director Compensation Payment amount would otherwise have been paid to the Director in cash. Any such election shall be made in increments of \$1,000 and must be made on or before the December 31 of the calendar year prior to the calendar year in which the services for the Director Compensation Payment which such Director is deferring into deferred stock units will be rendered and any such election shall be irrevocable as of such December 31.

(b) *Dividends.* Each time that a dividend is paid on Common Stock (other than a dividend of capital stock of the Company), a Director who is then credited with deferred stock units shall be credited with additional deferred stock units equal to the product of the dividend payment amount (or, if other than in cash, the Fair Market Value thereof) per share multiplied by the number of deferred stock units credited to such Director as of the record date for the dividend, divided by the Fair Market Value of the Common Stock on the dividend payment date.

(c) *Director Deferred Stock Unit Award Payouts.* At the time that a Director terminates such Director's service as a Director, the deferred stock units then credited to such Director shall be exchanged for whole shares of Common Stock which will be distributed to such Director. The value of any fractional share of deferred stock unit shall be paid in cash based upon the Fair Market Value of the Common Stock on the date of the termination of the Director's service as a Director. The transfer of shares of Common Stock (and payment of cash in lieu of fractional shares) to a Director in payment of such Director's deferred stock units shall be effected on the first of the month following the ninetieth day after the date such Director terminated such Director's position as a Director of the Company; provided, however, that such payment and transfer shall be deferred for a period of six (6) months after the date of such termination (or, if earlier, the date of death of the Director following such termination) unless such termination was by reason of any of the events described in Sections 409A(a)(2)(A)(ii), (iii), (iv), (v) or (vi) of the Code if such transfer (or payment) is a transfer (or payment) of amounts which would be considered to be compensation which was deferred after December 31, 2004.

## **XII. RECAPITALIZATION OR REORGANIZATION**

(a) *No Effect on Right or Power.* The existence of the Plan and the Awards granted hereunder shall not affect in any way the right or power of the Board or the stockholders of the Company to make or authorize any adjustment, recapitalization, reorganization or other change in the Company's or any Affiliate's capital structure or its business, any merger or consolidation of the Company or any Affiliate, any issue of debt or equity securities ahead of or affecting Common Stock or the rights thereof, the dissolution or liquidation of the Company or any Affiliate or any sale, lease, exchange or other disposition of all or any part of its assets or business or any other corporate act or proceeding.

(b) *Subdivision or Consolidation of Shares; Stock Dividends; and Recapitalizations.* The shares with respect to which Awards may be granted are shares of Common Stock as presently constituted, but if, and whenever, prior to the expiration of an Award theretofore granted, the Company shall effect a subdivision or consolidation of shares of Common Stock or the payment of a stock dividend on Common Stock without receipt of consideration by the Company, the number of shares of Common Stock covered by an Award (i) in the event of an increase in the number of outstanding shares shall be proportionately increased, and the purchase price per share shall be proportionately reduced, and (ii) in the event of a reduction in the number of outstanding shares shall be proportionately reduced, and the purchase price per share shall be proportionately increased. Any fractional share resulting from such adjustment shall be rounded up to the next whole share. If the Company recapitalizes, reclassifies its capital stock, or

otherwise changes its capital structure (a "recapitalization"), the number and class of shares of Common Stock covered by an Award theretofore granted shall be adjusted so that such Award shall thereafter cover the number and class of shares of stock and securities to which the Participant would have been entitled pursuant to the terms of the recapitalization if, immediately prior to the recapitalization, the Participant had been the holder of record of the number of shares of Common Stock then covered by such Award.

(c) Corporate Changes. Before or no later than thirty (30) days after a Corporate Change, the Committee, acting in its sole discretion without the consent or approval of any Participant, shall effect one or more of the following alternatives, which alternatives may vary among individual Participants and which may vary among Options held by any individual Participant: (1) accelerate the time at which Options then outstanding may be exercised so that such Options may be exercised in full for a limited period of time on or before a specified date (before or after such Corporate Change) fixed by the Committee, after which specified date all unexercised Options and all rights of Participants thereunder shall terminate, (2) require the mandatory surrender to the Company by all or selected Participants of some or all of the outstanding Options held by such Participants (irrespective of whether such Options are then exercisable under the provisions of the Plan) as of a date, before or after such Corporate Change, specified by the Committee, in which event the Committee shall thereupon cancel such Options and the Company shall pay (or cause to be paid) to each Participant an amount of cash per share equal to the excess, if any, of the amount calculated in Subparagraph (d) below (the "Change of Control Value") of the shares subject to such Option over the exercise price(s) under such Options for such shares, or (3) make such adjustments to Options then outstanding as the Committee deems appropriate to reflect such Corporate Change (provided, however, that the Committee may determine in its sole discretion that no adjustment is necessary to Options then outstanding), including, without limitation, adjusting an Option to provide that the number and class of shares of Common Stock covered by such Option shall be adjusted so that such Option shall thereafter cover securities of the surviving or acquiring corporation or other property (including, without limitation, cash) as determined by the Committee in its sole discretion. In exercising its powers to adjust Options as a result of a result of a corporate change pursuant to this subparagraph (c), the Committee shall exercise its best efforts to effect adjustments in a way that does not cause Options to become deferred compensation for purposes of the requirements imposed under section 409(a) of the Code. In the event of a Corporate Change, the Committee, acting at its sole discretion without the consent or approval of any Participant, may cause the Forfeiture Restrictions then remaining applicable with respect to all or selected Restricted Stock Awards or Restricted Stock Unit Awards to lapse as of a date before or after such Corporate Change as specified by the Committee. In the event of a Corporate Change, the Committee, acting in its sole discretion without the consent or approval of any Participant, may require the mandatory surrender to the Company by all or selected Participants of some or all of the outstanding Performance Awards or Phantom Stock Awards, as of a date before or after such Corporate Change specified by the Committee, in which event the Committee shall thereupon cancel such Performance Awards and Phantom Stock Awards and the Company shall pay (or cause to be paid) to each Participant an amount of cash equal to the maximum value (which maximum value may be determined, if applicable and in the discretion of the Committee, based on the then Fair Market Value of the Common Stock) of such Performance Award or Phantom Stock Award which, in the event the applicable performance or vesting period set forth in such Performance Award or Phantom Stock Award has not been completed, shall be multiplied by a fraction, the numerator of which is the number of days during the period beginning on the first day of the applicable performance or vesting period and ending on the date of the surrender, and the denominator of which is the aggregate number of days in the applicable performance or vesting period. Provisions of this Subparagraph (c) notwithstanding, the Committee may not and cannot take action pursuant to this Subparagraph (c) with respect to Awards which constitute deferred compensation that is subject to Section 409A of the Code unless (i) the Corporate Change in issue is a "change in control event" as such term is described in proposed or final Treasury Regulations promulgated pursuant to Section 409A of the Code and (ii) the action taken by the Committee constitutes an acceleration which is a permissible acceleration under proposed or final Treasury Regulations promulgated pursuant to Section 409A of the Code. Further, nothing in this Subparagraph (c) shall be interpreted to invalidate or otherwise adversely affect any provision in an individual

Award agreement regarding the effect of a Corporate Change upon the Award evidenced by such agreement and the Committee can exercise powers conferred upon the Committee pursuant to this Subparagraph (c) with respect to such Award only in a way which is consistent with and complimentary to any specific Corporate Change provisions of such Award Agreement.

(d) Change of Control Value. For the purposes of clause (2) in Subparagraph (c) above, the "Change of Control Value" shall equal the amount determined in clause (i), (ii) or (iii), whichever is applicable, as follows: (i) the per share price offered to stockholders of the Company in any such merger, consolidation, sale of assets or dissolution transaction, (ii) the price per share offered to stockholders of the Company in any tender offer or exchange offer whereby a Corporate Change takes place, or (iii) if such Corporate Change occurs other than pursuant to a tender or exchange offer, the Fair Market Value per share of the shares into which such Options being surrendered are exercisable, as determined by the Committee as of the date determined by the Committee to be the date of cancellation and surrender of such Options. In the event that the consideration offered to stockholders of the Company in any transaction described in this Subparagraph (d) or Subparagraph (c) above consists of anything other than cash, the Committee shall determine the fair cash equivalent of the portion of the consideration offered which is other than cash.

(e) Other Changes in the Common Stock. In the event of changes in the outstanding Common Stock by reason of recapitalizations, reorganizations, mergers, consolidations, combinations, split-ups, split-offs, spin-offs, exchanges or other relevant changes in capitalization or distributions to the holders of Common Stock occurring after the date of the grant of any Award and not otherwise provided for by this Paragraph XII, such Award and any agreement evidencing such Award shall be subject to adjustment by the Committee at its sole discretion as to the number and price of shares of Common Stock or other consideration subject to such Award. In the event of any such change in the outstanding Common Stock or distribution to the holders of Common Stock, or upon the occurrence of any other event described in this Paragraph XII, the aggregate number of shares available under the Plan, the aggregate number of shares that may be issued under the Plan through Incentive Stock Options, and the maximum number of shares that may be subject to Awards granted to any one individual may be appropriately adjusted to the extent, if any, determined by the Committee, whose determination shall be conclusive.

(f) Stockholder Action. Any adjustment provided for in the above Subparagraphs shall be subject to any required stockholder action.

(g) No Adjustments Unless Otherwise Provided. Except as hereinbefore expressly provided, the issuance by the Company of shares of stock of any class or securities convertible into shares of stock of any class, for cash, property, labor or services, upon direct sale, upon the exercise of rights or warrants to subscribe therefor, or upon conversion of shares or obligations of the Company convertible into such shares or other securities, and in any case whether or not for fair value, shall not affect, and no adjustment by reason thereof shall be made with respect to, the number of shares of Common Stock subject to Awards theretofore granted or the purchase price per share, if applicable.

### **XIII. AMENDMENT AND TERMINATION OF THE PLAN**

The Board in its discretion may terminate the Plan at any time with respect to any shares of Common Stock for which Awards have not theretofore been granted. The Board shall have the right to alter or amend the Plan or any part thereof from time to time; provided that no change in the Plan may be made that would impair the rights of a Participant with respect to an Award theretofore granted without the consent of the Participant, and provided, further, that the Board may not, without approval of the stockholders of the Company, (a) amend the Plan to increase the maximum aggregate number of shares that may be issued under the Plan, increase the maximum number of shares that may be issued under the Plan through Incentive Stock Options or change the class of individuals eligible to receive Awards under the Plan, or (b) amend or delete Paragraph VII(f).

#### XIV. MISCELLANEOUS

(a) *No Right To An Award.* Neither the adoption of the Plan nor any action of the Board or of the Committee shall be deemed to give any individual any right to be granted an Option, a right to a Restricted Stock Award, a right to a Restricted Stock Unit, a right to a Performance Award, a right to a Phantom Stock Award, or any other rights hereunder except as may be evidenced by an Award agreement duly executed on behalf of the Company, and then only to the extent and on the terms and conditions expressly set forth therein. The Plan shall be unfunded. The Company shall not be required to establish any special or separate fund or to make any other segregation of funds or assets to assure the performance of its obligations under any Award.

(b) *No Employment/Membership Rights Conferred.* Nothing contained in the Plan shall (i) confer upon any employee any right with respect to continuation of employment or of a consulting or advisory relationship with the Company or any Affiliate or (ii) interfere in any way with the right of the Company or any Affiliate to terminate his or her employment or consulting or advisory relationship at any time. Nothing contained in the Plan shall confer upon any Director any right with respect to continuation of membership on the Board.

(c) *Other Laws; Withholding.* The Company shall not be obligated to issue any Common Stock pursuant to any Award granted under the Plan at any time when the shares covered by such Award have not been registered under the Securities Act of 1933, as amended, and such other state and federal laws, rules and regulations as the Company or the Committee deems applicable and, in the opinion of legal counsel for the Company, there is no exemption from the registration requirements of such laws, rules and regulations available for the issuance and sale of such shares. No fractional shares of Common Stock shall be delivered, nor shall any cash in lieu of fractional shares be paid. The Company shall have the right to deduct in connection with all Awards any taxes required by law to be withheld and to require any payments required to enable it to satisfy its withholding obligations.

(d) *Section 409A Acceleration.* The Committee may at any time cause the acceleration and payment of an amount under an Award at any time such Award fails to meet the requirements of Section 409A of the Code; provided, however, that the accelerated payment shall not exceed the amount required to be included in income of the Award holder as a result of such failure to comply with the requirements of Section 409A of the Code.

(e) *No Restriction on Corporate Action.* Nothing contained in the Plan shall be construed to prevent the Company or any Affiliate from taking any action which is deemed by the Company or such Affiliate to be appropriate or in its best interest, whether or not such action would have an adverse effect on the Plan or any Award made under the Plan. No Participant, beneficiary or other person shall have any claim against the Company or any Affiliate as a result of any such action.

(f) *Restrictions on Transfer.* An Award (other than an Incentive Stock Option, which shall be subject to the transfer restrictions set forth in Paragraph VII(c)) shall not be transferable otherwise than (i) by will or the laws of descent and distribution, (ii) pursuant to a qualified domestic relations order as defined by the Code or Title I of the Employee Retirement Income Security Act of 1974, as amended, or the rules thereunder, or (iii) with the consent of the Committee, but in no event can any Award granted hereunder be transferred for value.

(g) *Governing Law.* The Plan shall be governed by, and construed in accordance with, the laws of the State of Delaware, without regard to conflicts of laws principles thereof.

Pier 1 Imports, Inc.

By: \_\_\_\_\_  
Gregory S. Humenesky  
Executive Vice President, Human Resources

**Pier 1 Imports, Inc.**  
SHAREHOLDER INFORMATION

**EXECUTIVE OFFICES**

100 Pier 1 Place  
Fort Worth, Texas 76102  
817-252-8000  
www.pier1.com

**COMMON STOCK**

Approximately 9,600 shareholders of record  
Traded on the New York Stock Exchange (the "NYSE")  
Symbol: PIR

**INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Ernst & Young LLP  
Fort Worth, Texas

**TRANSFER AGENT**

Mellon Investor Services  
85 Challenger Road  
Ridgefield Park, New Jersey 07660  
Shareholder Line Toll Free 1-888-884-8086

**ANNUAL MEETING**

The annual meeting of shareholders will be held at  
10 a.m. Central Daylight Time, Thursday, June 22, 2006,  
in the Trinity Room of the Fort Worth Club, Fort Worth, Texas.

**FORM 10-K REPORT AND INVESTOR RELATIONS**

The Company has included as an Exhibit to its Form 10-K report filed with the Securities and Exchange Commission certificates of the Company's Chief Executive Officer and Chief Financial Officer certifying the quality of the Company's public disclosure. The Company's Chief Executive Officer also has submitted to the NYSE a certificate certifying that he is not aware of any violations by the Company of the NYSE corporate governance listing standards.

A copy of the Pier 1 Imports, Inc. Form 10-K report filed with the Securities and Exchange Commission is available on the Investor Relations section of the Company's Website at [www.pier1.com](http://www.pier1.com) or by writing the Investor Relations Department at:

Pier 1 Imports, Inc.  
P.O. Box 961020  
Fort Worth, Texas 76161-0020

or by calling 1-817-252-7835  
Toll Free 1-888-80-PIER1 (1-888-807-4371)

Investor inquiries also may be directed to that department.

**Pier 1 Imports, Inc.**  
DIRECTORS AND OFFICERS

**BOARD OF DIRECTORS**

Marvin J. Girouard  
Chairman and  
Chief Executive Officer

John H. Burgoyne  
Founder  
Burgoyne and Associates

Dr. Michael R. Ferrari  
President  
Ferrari and Associates LLC

James M. Hoak, Jr.  
Chairman  
Hoak Capital Corporation

Karen W. Katz  
President and Chief Executive Officer,  
Neiman Marcus Stores

Terry E. London  
President,  
London Partners LLC

Tom M. Thomas  
Shareholder  
Winstead Sechrest & Minick, PC

**EXECUTIVE OFFICERS**

Marvin J. Girouard  
Chairman and  
Chief Executive Officer

Charles H. Turner  
Executive Vice President, Finance,  
Chief Financial Officer  
and Treasurer

Jay R. Jacobs  
Executive Vice President,  
Merchandising

E. Mitchell Weatherly  
Executive Vice President,  
Stores

Phil E. Schneider  
Executive Vice President,  
Marketing

David A. Walker  
Executive Vice President,  
Logistics and Allocations

Greg S. Humenesky  
Executive Vice President,  
Human Resources

**Pier 1 imports®**